Business succession agreements - disablement and death

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1. INTRODUCTION

The issues involved in developing and implementing a business succession strategy can be surprisingly complex.

In this paper I have been asked to focus on the issues involved and strategies for dealing with the unplanned exit of an equity holder as a consequence of death or disablement. Business succession agreements covering these unplanned exits are usually underpinned by life insurance policies providing both death and total and permanent disablement (TPD) cover.

2. TAX BACKGROUND

As I have already mentioned, business succession planning is an unduly complex area given the relatively simple objective, which is to plan for the inevitable departure of equity holders in a business whether as a consequence of retirement, death or disablement.

This complexity arises largely because of the capital gains tax provisions. This is both surprising and disappointing given that the transfer of equity interests as a result of death and disablement is not likely to be a fruitful area of tax avoidance and the ATO and Treasury have been well aware of the technical problems that exist for many years.

The ATO released a draft ‘Discussion Paper’ in 2000 outlining its views on the capital gains tax implications of alternative business succession models. The Discussion Paper identified a range of capital gains tax issues that had potential impact on alternative business structures including:

- the relevant date of disposal and acquisition of the business interests;
- determination of the capital proceeds received by the outgoing equity holder for their business interest;
- whether the market value substitution rule applies for the purpose of determining the capital proceeds received by an outgoing equity holder;
- the effect of the grant, exercise, lapse or assignment of put and call options;
- if an insurance trust is used, the nature of the beneficiaries’ interests and the tax treatment of the insurance proceeds received by the trustee and amounts received by the beneficiaries;
- capital gains tax exemptions for life insurance policy proceeds; and
- capital gains tax exemptions for compensation received under TPD policies.

When the Discussion Paper was released, the ATO indicated it would not issue a public ruling but that the Discussion Paper set out their views on the tax implications of alternative approaches. At the NTLG meeting in December 2010 the ATO indicated that the Discussion Paper had been removed from the ATO website and that practitioners should not rely on it. However, the views expressed in that document are still of some use given the lack of any substantive material outlining the ATO’s view on the implications of business succession arrangements.

3. ALTERNATIVE MODELS

Several different approaches have been developed by life insurance companies and advisers in structuring business succession agreements. The differences between the various approaches relate either to the nature of the agreements themselves or the way in which the ownership of the insurance policies that underpin the agreements are structured.
The two predominant structures for the actual business succession documentation are:

- ‘mandatory’ buy/sell agreements; or
- put and call options.

The most common approaches to the ownership of the insurance policies are:

- cross ownership;
- self-ownership; or
- insurance trusts.

There are some quite strongly held views as to which of these alternative models is preferable. As with many things, there is not necessarily one correct answer and the appropriate structure for different clients may depend upon their circumstances.

4. MANDATORY AGREEMENTS V PUT & CALL OPTIONS

The expression ‘mandatory agreements’ is usually used to describe arrangements where the parties agree that, if one of the parties dies or becomes permanently disabled, that party or their estate must sell their interest in the business to the other parties.

There is some confusion as to the capital gains tax consequences of agreements that are structured in this way.

If a triggering event does occur under a mandatory agreement, the capital gains tax implications will depend upon whether the trigger event (usually death or disability) is a condition precedent or condition subsequent.

The issue of whether a condition is a condition precedent or a condition subsequent is a complex one involving fine legal distinctions.1

The significance of the distinction is that, if the trigger event is a condition precedent, there is no contract formed until that trigger event occurs and therefore, the date of the relevant CGT event (A1) is the date of the trigger event not the date of the agreement.

However, if the trigger event is not a condition precedent but is a condition subsequent that must be satisfied before completion of the transaction, the date of the CGT event will be the date of the business succession agreement and not the date of the trigger event.

In *Carter on Contract*2, the author notes that

> The mere fact that the parties have indicated that the contract is to some extent conditional does not show that there is no contract until the event occurs. Indeed, the position has now been reached that, except where the expression ‘subject to contract’ is used in a sale of land context, it is presumed that the purpose is to condition the performance rather than the existence of the contract. Nevertheless, to express the question in the language of conditions precedent, in all cases the question is whether fulfilment of the contingency is a condition precedent to the existence of a contact.3

The author also makes the following observation on the state of the law in Australia in relation to the distinction between conditions precedent and conditions subsequent:

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2 LexisNexis on line service
3 At paragraph [05-001]
At one time it was reasonably common for courts to interpret clauses expressed in general terms as bringing the agreement within this class [i.e. conditions precedent]. The problem with such decisions is that they leave open a right to retire from the contract at any time prior to satisfaction of the contingency.

Consistently with the current impetus for a requirement of good faith in contract, nearly all the principal authorities have been doubted. 4

In its Discussion Paper, the ATO indicated a willingness to treat the death or disability event as a condition precedent to the contract and stated that ‘provided that it is clear from a buy/sell agreement that it is the proprietors’ intention that the agreement does not become binding until the death of one of them, we will accept that the time of the contract’ is the date of death or disablement. Similar statements appear in ATO ID 2004/668.

However, there are risks involved in assuming the ATO will always accept that business succession agreements that have death and disability as the trigger event are subject to a condition precedent, including the following:

- The ATO has indicated that advisers should not rely on anything contained in the Discussion Paper.
- In any event, the ATO analysis in the Discussion Paper appeared to presume that the funding arrangements (in relation to the insurance policies) will be covered in a separate agreement which is not usually the case.
- The position adopted by the ATO in the Discussion Paper and ID 2004/688 depends on the parties being able to establish that their intention was not to create a binding agreement when the agreement was signed. The main purpose in having a business succession agreement is that the parties want the agreement to be binding from the date of signing and therefore, the presumption on which the ATO view is based may not be applicable in many cases.
- The judicial trend appears to be to interpret ‘subject to’ conditions as being conditions subsequent and not pre-conditions to the formation of a contract as noted in the above extract from Carter.

Even if a business succession agreement that provides for the sale of a business interest on death/disability is not subject to a condition precedent, the signing of the agreement will not trigger an immediate disposal. CGT event A1 will only occur when the actual transfer of the business interest is completed.5

However, once there is an actual disposal, section 104-10(3) requires that the capital gain should be determined as if the disposal had occurred at the date of the business succession agreement.

There are some significant issues arising from the use of a mandatory agreement that is subject to a condition subsequent.

Firstly, the actual disposal may occur many years after the date the agreement is signed and there will be significant practical problems in retrospectively calculating the disposing party’s capital gains tax liability and lodging amended returns.

There may also be an issue of whether the general interest charge will be payable but, in Taxation Determination TD 94/89 the ATO indicated that interest penalties will generally be remitted if the amended return is lodged promptly after the actual disposal occurs.

A more significant problem will arise if the mandatory business succession agreement is signed at or about the same time as a party acquires their interest in the business. If that person subsequently dies or is disabled and their business interest is sold pursuant to the agreement, the deemed date of disposal under section 104-10(3) will be the date of the agreement, which will be within 12 months of the date on which the business interest was acquired.

4 At paragraph [05-040]
5 Taxation Determination TD 94/89
The consequence of this is that the capital gain on the disposal of the business interest will not be a discount capital gain under Division 115 and the disposing party or the estate will not be entitled to the 50% discount that would otherwise have been available.

If the requirement that one of the parties must die or become disabled is a condition precedent, the date of the contract will be the date on which the condition precedent is satisfied and these problems will not arise.

Because of the uncertainty and possible detrimental consequences arising from the use of mandatory agreements, my view is that it is safer to have an agreement with reciprocal put and call options rather than a conditional sale agreement.

There are conflicting case authorities as to the legal effect of an option.6

Some authorities have favoured the view that a call option is nothing more than a conditional contract.7 On the other hand there are authorities that indicate that the grant of a call option is nothing more than an offer and that no contract is formed until the offer is accepted.8

The correct characterisation of an option appears to depend very much on how the option is drafted. If it is clear that the option is nothing more than an offer and that no contract is formed until the offer is accepted then it is likely that there will be no contract formed until the offer is accepted. The ATO in the few rulings and other publications in which it has dealt with put and call options (particularly in the context of business succession matters) appear to accept that an option constitutes an offer rather than a conditional contract.9

The capital gains tax consequences of put and call options that are not characterised as conditional contracts are much clearer (at least in relation to the timing of the subsequent CGT event). In Taxation Determination TD 16, the ATO confirmed that the date of disposal of an asset as a consequence of the exercise of an option is the date on which the option is exercised.

In its Discussion Paper, the ATO also stated that ‘the time of any disposal or an acquisition of a business interest that results from the exercise of an option will be the date the option is exercised’ not the date of the option agreement.10

While it is clear that the date of CGT event A1 will be the date of exercise of the option, any capital gain the seller makes on the sale of their interest may not be a discount capital gain if the put/call option is entered into within 12 months of the date of acquisition of the interest – even if the option is exercised many years later.

Section 115-40 provides that a capital gain will not be a discount capital gain if the relevant CGT event ‘occurred under an agreement you made within 12 months of acquiring the CGT asset’. It appears that a put or call option entered into within 12 months of acquiring the equity interest in the business would be caught by this provision.

The Explanatory Memorandum that accompanied the introduction of the discount capital gains tax provisions 11 provides no assistance as to how this provision will be applied. It merely says that the section will ‘prevent taxpayers inappropriately taking advantage of the CGT discount by seeking to extend artificially the period of ownership.’ Unfortunately the section itself does not contain any reference to ‘inappropriate’ or ‘artificial’ agreements.

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6 Laybutt v Amoco Australia Pty Ltd 132 CLR 57, Goldsborough Mort & Co Ltd v Quinn 10 CLR 674, Commissioner of Taxes (Qld) v Caphin 57 CLR 127.
7 For example, Goldsborough Mort & Co Ltd v Quinn 10 CLR 674 at 678.
8 Commissioner of Taxes (Qld) v Caphin 57 CLR 127 at 132.
9 For example, ATO ID 2003/1190.
10 At page 19
This issue was discussed at the November 2001 NTLG meetings and the ATO view recorded in the minutes was that ‘section 115-40 is intended to apply in circumstances where put or call options have been used’.

Therefore, caution is required in entering into put or call options within 12 months of the date a party acquires their interest in the business.

The grant of the option is itself a separate CGT event (event D2) and there are several issues that need to be considered in determining the CGT consequences of the grant of the option. The first is when CGT event D2 occurs and the second is whether there is any actual or deemed market value consideration for the grant of the option.

Similar issues arise in relation to put and call options as for mandatory agreements - in relation to whether the agreement is subject to a condition precedent or condition subsequent. For reasons outlined earlier in this paper, my view is that the grant of an option that is only exercisable on the occurrence of a trigger event such as death or disability is not subject to a condition precedent because the parties intend to be bound by the option agreement from the date it is signed.

However, as with Mandatory agreements, the ATO appears to take a more benevolent view and has indicated that the grant of options under a business succession agreement that are exercisable only in the event of death or disability of a party are subject to a condition precedent and therefore CGT event D2 does not occur until the relevant trigger event occurs.\(^{12}\)

If CGT event D2 occurs when the option agreement is signed (which is the more likely outcome in my view) there should generally be no CGT consequences because there will be no material consideration provided for the options and, although the market value substitution rule may apply, the market value of the rights granted under the option will be nominal for a number of reasons including that:

- the business succession agreement will normally stipulate that the options are personal to the grantees and are not assignable; and
- the option will only ever be exercisable in the event that the relevant party granting the option dies or becomes totally and permanently disabled – which may never happen.

In the Discussion Paper the ATO accepted that reciprocal options granted in these circumstances would have a nil market value.

5. **TAXATION TREATMENT OF TPD BENEFITS**

A major area of confusion with these alternative approaches arises as a result of uncertainty as to the nature of the capital gains tax exemption for TPD benefits. Therefore before analysing the different models in detail, it is necessary to examine the capital gains tax treatment of insurance proceeds paid under the relevant insurance policies when a trigger event occurs.

The resolution of this issue depends in turn upon whether the payment of a TPD benefit is treated as being a payment under a ‘life insurance policy’ that can be disregarded under section 118-300 of the 1997 Tax Act or whether that payment can only be disregarded under section 118-37, which applies to compensation for ‘damages you receive for any wrong, injury or illness you or your relative suffers’.

The first question to consider is what is a ‘life insurance policy’ because section 118-300 exempts the proceeds paid on a ‘life insurance policy’ in any of the circumstances listed in the table to that section.

The expression ‘life insurance policy’ is defined as having the same meaning as ‘life policy’ in the *Life Insurance Act 1995*.\(^ {13}\) Section 9 of the *Life Insurance Act 1995* defines a ‘life policy’ as encompassing

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\(^{12}\) ATO ID 2003/1190 and Private Binding Ruling 81561

\(^{13}\) Section 995-1 – 1997 Tax Act
any one of seven different types of policies, one of which includes ‘a continuous disability policy’ that would cover TPD policies.

The difficulty is that, the proceeds received under a ‘life insurance policy’ can only be disregarded under section 118-300 in the situations set out in the table to that section.

The relevant items in the table are 3 and 4 that provide that the capital gain arising from an insurance payout can be disregarded where there is ‘a policy of insurance on the life of an individual …’.

That is, even though proceeds must be paid under a policy that falls within the definition of ‘life insurance policy’ that policy must still be a policy ‘on the life of an individual’ and the ATO view is that a TPD policy does not meet that requirement.14

Therefore, a payment under a TPD policy will only be exempt from capital gains tax if it meets the requirements of section 118-37, which applies to compensation payments for illness or injury suffered by the recipient of the payment or a relative of that person.

6. PROBLEMS WITH CROSS OWNERSHIP OF POLICIES

Under the cross ownership model the insurance policies that underpin the business succession arrangements are owned by the other business owners and not the person who is the life insured. If a TPD event occurs in those circumstances, the TPD benefit will not be exempt from capital gains tax as section 118-300 will not apply and the recipient of the proceeds will not be within the permitted categories under section 118-37 (i.e. the insured or a relative).

This could have a dramatic effect on the net amount available to pay out a retiring owner and is a compelling reason to avoid cross ownership of policies where there is a TPD component.

Even if the insurance policies only provide for a death benefit there may also be capital gains tax disadvantages under the cross ownership model.

The payment of a death benefit under an insurance policy is only disregarded under section 118-300 where the entity that makes the capital gain was ‘the original beneficial owner of the policy’ or ‘acquired the interest in the policy or instrument for no consideration’.

These conditions can create difficulties if there are any changes in the ownership of policies as a result of entries or exits of equity holders in the business. For example, an incoming owner may acquire an interest in existing policies over the lives of continuing owners in which case the new owner will not be the ‘original beneficial owner’ of the policy. Therefore, if a death benefit is subsequently paid, the question arises whether the party has acquired its interest in the policy for ‘no consideration’.

While there may be no specific cash consideration payable for the assignment of interests in insurance policies on the entry or exit of business owners, the assignment of an interest in cross owned business succession policies will generally be part of a wider transaction that involve mutual promises and this is sufficient to constitute ‘consideration’ in the contractual sense. Arguably, this means that a party who is not an original beneficial owner but acquires an interest in a policy in circumstances relating to the exit or entry of business owners, may not be able to claim the exemption on the proceeds.

The concept of ‘consideration’ is not defined in the 1997 Tax Act but the ATO considered that ‘consideration’ where used in section 160M(7) of the 1936 Tax Act should be given its normal contractual meaning, which extends to the exchange of mutual promises.15 In the absence of any expressed definition of ‘consideration’ in the 1997 Act, it is reasonable to conclude that the same interpretation will be given to that term in section 118-300.

14 TD 2007/4
15 Taxation Ruling TR 95/3 – paragraphs 101 - 117
Therefore, in my view, it is preferable to avoid cross ownership of policies if the policies include a TPD component or if there is any prospect of changes in ownership of the policies on the entry or exit of business owners.

7. SELF-INSURANCE

The ‘self-ownership’ model does not necessarily mean that the policy must be owned by the individual whose life is insured. The concept refers to an ownership structure where the person or entity that originally acquires the policy is either the business owner, a relative or entities controlled by the party (such as a trustee of a superannuation fund). This provides considerable flexibility in terms of estate planning.

Under this ownership structure, the issues relating to whether TPD benefits are exempt and whether the party is the original beneficial owner or has acquired the policy for no consideration simply will not arise.

The certainty that this approach provides is, in my view, a very strong reason to opt for self-ownership of policies in lieu of cross ownership.

8. INSURANCE TRUSTS

An approach that is quite common is to establish a separate insurance trust to hold the insurance policies taken out as part of the business succession arrangements.

My own view is that the establishment of an additional trust may add unnecessary complexity and expense without adding any significant benefits.

There is also an element of uncertainty as to whether the proceeds of policies held in insurance trusts will be exempt from capital gains tax.

My understanding is that the ATO will accept that there are no adverse capital gains tax consequences if death or TPD benefits are paid to an appropriately structured insurance trust. In its Discussion Paper, the ATO confirmed that insurance trusts would be acceptable in certain circumstances but with qualifications.

The Discussion Paper suggests that insurance proceeds received by the trustee of an insurance trust will be disregarded in some circumstances but it may be necessary that the trust is a ‘bare trust’ or that the trustee is a relative of the person whose life is insured (at least in the case of receipt of TPD benefits).

I understand that the ATO has issued favourable private rulings in relation to some insurance trust arrangements and has also issued a product ruling confirming that payment of TPD proceeds to the trustee of an insurance trustee would be exempt from CGT. The product ruling was based on a number of assumptions including that the beneficiary (the insured person) was absolutely entitled to the rights under the insurance policy.

If the obiter dictum statements in Oswal v Commissioner of Taxation are correct, it may be very difficult for any beneficiary to have absolute entitlement to trust assets.

Given the qualifications in the Discussion Paper, the fact that clients cannot rely on private rulings and the difficulties in establishing that a beneficiary is absolutely entitled, my view is that there will always be a tax risk if using insurance trust arrangements, unless the arrangement is subject to a product or private ruling.

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16 PR 2010/18
17 [2013] FCA 745
18 Refer TR 2004/D25
However, there will be situations where it may be the preferred option – for example if the equity interests of the business owners are subject to a registered security and it will be necessary to ensure that the proceeds will be applied to pay out the security holder to ensure the equity interests can be transferred in accordance with the business succession agreement or where the parties take out additional insurance that is intended to be applied to reduce business debt.

9. DETERMINATION OF CAPITAL PROCEEDS

Some difficult questions arise in determining what are the actual capital gains tax implications for the parties when a trigger event occurs, particularly where the actual purchase price payable by the continuing parties is less than market value of the business interest, because the outgoing party or their estate or dependants have already received the proceeds from the insurance policy.

Where the self-insurance model is used, it is quite common for the business succession agreement to provide that the outgoing party or their estate or dependants will transfer their business interest for nominal consideration or for an amount that is equal to the difference between market value and the policy proceeds.

In those circumstances, the question is whether the market value substitution rule will apply to deem the capital proceeds from the CGT event to be equal to market value. If the market value substitution rules apply, the continuing parties will be deemed to have a cost base equal to market value rather than the amount actually paid.

The market value substitution rule is contained in section 116-30 of the 1997 Tax Act. It applies if:

- the capital proceeds that are paid or received are less than market value of the business interest; and
- the parties to the transaction do not ‘deal with each other at arm’s length in connection with’ the relevant CGT event.

The key issue therefore is whether the continuing parties and the retiring party or their estate will be considered to be dealing with each other at arm’s length in relation to the determination of the price for the business interest of the outgoing party.

In most cases, the parties under a business succession agreement will be ‘at arm’s length’ in that they will generally not be related to each other. However, parties who are at arm’s length and who enter into a bona fide commercial transaction, may still not be ‘dealing’ at arm’s length in relation to certain aspects of the transaction, particularly the setting of the purchase price.\(^\text{19}\)

In Collis, the Court held that ‘dealing at arm’s length’ meant there must be a genuine bargaining process and, if one of the parties is indifferent to the price or apportionment that is inserted, the parties may not be dealing at arm’s length.

In a business succession situation, the party or estate that receives the benefit of the insurance proceeds may well be indifferent to the total consideration actually payable by the continuing parties because the bulk of the cash proceeds will come from the policy. So long as the total of the insurance proceeds and the purchase price paid is equivalent to market value, they will generally be satisfied.

In the Discussion Paper, the ATO expressed the very strong view that, irrespective of the fact that all of the parties to a business succession agreement may be ‘at arm’s length’ and may all be subject to the same potential risks and benefits at the time they enter into the business succession agreement, the ATO did not accept that all transactions arising under the agreement will be arm’s length transactions and appeared to assume that the mere fact that the cash consideration payable is less than market value raises a presumption that the parties are not dealing at arm’s length.

\(^{19}\) Collis v FCT 96 ATC 4831
The consequences of the ATO view are that, if the agreement the parties have struck is that the continuing parties pay less than market value, the market value substitution rule will apply and the outgoing party or their estate will be deemed to receive capital proceeds equal to market value.

Similarly, the ongoing parties will be deemed to have a cost base equal to market value. This position appears to be at odds with the ATO’s views in Taxation Ruling TR 2002/2, which considers the ‘arm’s length’ concept in section 47A(7) and in which the following statement occurs:

> By necessity, the arm’s length test must be considered from the perspective of both provider/lender and recipient/borrower. It considers what independent parties acting in their own commercial interests in situations comparable to those of the relevant parties to the loan would have negotiated. It is an objective test that takes into account whether the loan is commercially realistic.

While the precise wording in section 47A(7) is not the same as in the market value substitution provisions, there is an argument that, the arm’s length test should be satisfied where it can be objectively concluded that the terms of the agreement are what would be expected in an agreement between independent parties who are dealing at arm’s length even though the actual cash consideration payable on exercise of an option may be less than market value.

### 10. IMPORTANCE OF CERTAINTY

While the capital gains tax and other technical issues referred to above are important in evaluating the alternative business succession structures, the fundamental objective should be to ensure that the insurance proceeds that underpin the arrangements are received by the correct party.

In my opinion, one of the more compelling reasons to structure the insurance arrangements under the self-insurance model is that there will be no doubt that the insurance proceeds will be received by the estate or dependants of the deceased business owner because they will be the only persons eligible for payment under the policy.

With the cross ownership and insurance trust models the insurance proceeds will initially be paid to a third party. The estate or dependants will have contractual rights to require those third parties to deal with the proceeds as they direct, but there are always issues of enforceability and collectability with any contractual right.

For example, if the third party who receives the policy proceeds happens to be insolvent at the time or simply refuses to comply with the business succession agreement this can place the estate or dependants in a difficult position particularly if they have an urgent need for the funds. However, as mentioned above, if the equity interest that is to be acquired is subject to a charge, the insurance trust may provide greater certainty.

### 11. DEBT INSURANCE

In some cases, clients will take out insurance not only to provide funding to compensate an outgoing owner or their estate for their equity in the business but also to provide additional funds to either retire or reduce business debt.

This does add some complications where the policies are held by the individuals whose lives are insured or their related parties as it is necessary to ensure they can be compelled to actually pay the amount of the policy proceeds earmarked for debt retirement to the lender or back into the business.

This is another area where an insurance trust may provide some benefits because the trustee can be directed to pay portion of the proceeds to the financier and only the balance to the outgoing party or estate.

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20 paragraph 25
21 sections 112-20 and 116-30
However, if the ‘debt component’ of the cover is paid directly to the financier, this may deny the outgoing party or estate the opportunity to claim the additional payment as part of the cost base of their interest in the business. This may have a significant impact on the net capital gain arising from the disposal of that business interest.

On the other hand if the outgoing party or the estate receives the insurance proceeds and is required to pay part of the proceeds to reduce business debt, this will enhance the net value of the CGT asset comprising their business interest and they should be entitled to claim this expenditure as part of the fourth element of the cost base under section 110-25(5).

A concern that is raised in relation to this strategy is whether there is a risk that the party who receives the insurance payout will refuse to pay the required amount to the financier.

The first point in relation to this concern is that there will usually be a compelling reason for the party to comply with the debt reduction obligations. The retiring or deceased party will generally be personally liable for the business debt (either because they are a partner or a guarantor) and therefore it will be in their interest to ensure that they are released from personal liability for the debt. If the only way they can secure a release is to pay the debt reduction amount to the financier this is a compelling reason for them to comply.

Also, if additional security is required, the policies can be assigned to the financier as collateral security for the business debt without any significant cost.

### 12. PRACTICAL ENFORCEMENT

A further practical issue is to ensure not only that the policy proceeds go to the correct parties but that the transfer of the interest of the retiring or deceased party is effected with minimum disruption to the business operations.

This is another area where some people have a degree of discomfort with the self-ownership concept because the insurance proceeds will be received by the outgoing party or their estate or dependants and the continuing parties will merely have contractual rights to require those parties to assign their interest in the business.

This potential problem can be reduced or eliminated if the business succession agreement includes an irrevocable power of attorney in which each of the parties appoint the others as their attorneys for the purpose of signing any documentation necessary to transfer their interest in the business once a triggering event has occurred (subject to insurance proceeds being paid).

Provided that the power of attorney is stated to be irrevocable and is given to secure the performance of an obligation owed by the grantor to the attorney, the power of attorney will not be revoked as a consequence of the death or incapacity of the grantors.\(^{22}\)

Section 10 of the *Powers of Attorney Act 1998 (Qld)* specifically states that a power of attorney given as security to secure the performance of an obligation owed to the attorney ‘is incapable of revocation’ except with the consent of the attorney or by the performance of the obligation that is secured.

This ability to grant an irrevocable power of attorney is not widely appreciated and is an under utilised option. However, it provides the continuing parties with the power to ensure that any assignments that are necessary to implement the business succession arrangements can be implemented with a minimum of inconvenience and disputation.

### 13. USE OF SUPERANNUATION

While many clients can see the benefits of having a business succession agreement that is underpinned by insurance policies, many are put off by the fact that the insurance premiums are not

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\(^{22}\) *Section 10 - Powers of Attorney Act 1998 (Qld)*
deductible. Therefore they may prefer to hold the insurance arrangements in their superannuation fund and claim deductions for the insurance proceeds.

Under the self-ownership model, the business succession agreement will be triggered if a party dies or is permanently disabled and the proceeds of a specified insurance policy are paid. It is not necessary to specify to whom the proceeds will be paid so long as the policy itself is sufficiently identified.

There is therefore no reason why the business owners cannot agree that, if the triggering event occurs and a policy owned by their superannuation fund is paid out, this triggers their obligation to sell their business interest under the business succession agreement.

The obvious attraction for some clients is that the premiums then become deductible and the insurance proceeds will not be assessable income of the superannuation fund.

In my opinion, there are no compliance difficulties in utilising a client’s superannuation fund as part of the business succession agreements. The main compliance issue that is sometimes raised is whether there is any breach of the sole purpose test if an insurance policy taken out as part of business succession arrangements, is held in a complying superannuation fund.

All that the sole purpose test requires is that the superannuation fund must be maintained solely for one of the ‘core purposes’ outlined in section 62 of the Superannuation Industry (Supervision) Act 1993. In the context of business succession arrangements, the relevant core purposes are:

- the provision of benefits for members on retirement; or
- the provision of benefits to dependants of a member as a consequence of their death.

In my opinion, there can be no question that, if the superannuation fund holds a policy to provide a benefit if a person’s interest in a business is terminated as a result of death or TPD, this falls within the required core purposes. The whole purpose of the arrangement is to provide insurance funding for the member or dependants on their exit from the business.

Several years ago, our firm obtained written confirmation that, so long as the business succession arrangement did not attempt to prescribe how the superannuation trustee should deal with insurance benefits, there would be no breach of the sole purpose test if the superannuation trustee held the insurance policy that underpinned the business succession arrangements.

If the insurance policies taken out by the clients include an amount earmarked for debt reduction, then holding the policies in a superannuation fund raises additional issues.

It is not possible to have an arrangement where the trustee is bound to act in accordance with the business success agreement (in terms of paying the debt component to the relevant financiers. This makes the whole arrangement (particularly the enforceability, somewhat uncertain.

It is possible for the relevant party to make a binding nomination directing the trustee of the superannuation fund to pay all or part of the insurance proceeds into their estate and generally the estate will then be obliged to make the debt reduction payment to the financier because it will be bound by the terms of the business succession agreement. However, this only covers a death situation and does not provide any enforcement mechanism where the insurance proceeds are paid as a result of a trauma or TPD event. Also, there is no way for the continuing parties to monitor whether a person who has made a binding nomination revokes or varies that nomination.

14. MUTUAL WILLS

Where equity holders in the business are individuals, there may be some advantages in those individuals gifting their equity interests to the continuing parties in the business under their Wills, but caution is required if adopting this approach.
This approach was more common prior to the introduction of amendments to the small business concessions in 2007, which provided that the concessions were available in relation to CGT events occurring up to two years after the death of a deceased owner because, prior to those amendments, the small business concessions were not available at all where the party disposing of the active assets were either the executors or beneficiaries of an estate.

However there may still be some advantages if assets are disposed of under the Will of the deceased equity owner. For example, stamp duty is not payable on a transfer of assets pursuant to the terms of a Will.

Also, if the party (or their estate) is unlikely to be able to access the small business CGT concessions, then providing for the asset to transfer pursuant to the Will may mean that the estate suffers no CGT consequences as a result of the transfer of the asset.

The acquiring party in that situation however will only acquire the asset with the same cost base as the deceased, which may mean that they are effectively acquiring an asset with a significant unrealised capital gain.

This approach would generally only be adopted where the parties had taken out business succession insurance under the ‘self-ownership’ model and the parties’ Wills would have to be drafted so that the gift of the business assets to the continuing parties was conditional upon the insurance proceeds having been received by the estate (or relevant party that owned the policy).

It is also important to appreciate that this approach will never be a satisfactory ‘stand alone’ option, as there are a number of situations where reliance on reciprocal Wills will not achieve the desired result. For example:

- one of the parties may change their Will;
- the Will may be invalid for any number of reasons; and
- the Will of the deceased party may be challenged.

This means that if reciprocal Wills are utilised as part of the business succession strategy, it is also necessary to have a call option arrangement in place so that if for any reason the provisions in the Will transfer into business assets are not effective, the continuing parties can revert to exercising the option.

15. SHARE BUY BACKS – DO THEY HAVE A PLACE?

Where the business is carried on through a company, it is not uncommon to see provisions in shareholder agreements and buy-sell agreements that, if a relevant trigger event occurs the continuing parties have the option of implementing a share buy-back rather than the continuing parties purchasing the shares from the deceased/disabled party or their related entity.

A perceived advantage of this is that, if the company buys back the shares (rather than the continuing parties purchasing the shares) the company can fund the purchase without the need for the ongoing parties to take dividends or enter into Division 7A loan agreements.

While a share buy-back arrangement may provide a more effective funding arrangement for the ongoing parties it is important to appreciate that the tax consequences of a share buy-back may be substantially different to a sale of shares by the outgoing party.

A potential disadvantage is that, if a party has paid significant consideration but their shares, but those shares have only a nominal paid up capital, the disposal of the shares under a share buy-back will mean that the party does not get any benefit from the cost base on those shares.

23 Section 152-80
The reason for this is that, in most circumstances, the amount by which the buy-back price exceeds the paid up capital will generally be taxable as a dividend – whereas if the shares are sold only the portion of the sale price that exceeds the cost base of the shares will be subject to tax.\(^{24}\)

In addition the disposing party will generally be able to access the 50% general discount under Division 115 and possibly the small business CGT concessions if they sell their shares but none of the CGT concessions are available on a share buy-back.

Also, if the buy-back price is less than market value (e.g. because the price has been reduced by the insurance proceeds), the deemed dividend will be the market value.\(^{25}\)

Therefore there will only be limited (if any) instances where a share buy-back is a viable option for a business succession strategy – at least from the perspective of the parties who will be disposing of their shares.

If you would like to find out more please contact:

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This paper is only intended as a general overview of issues relevant to the topic and is not legal advice. If there are any matters you would like us to advise you on in relation to this paper, please let us know.

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\(^{24}\) Refer to PS LA 2007/9 – paragraph 12

\(^{25}\) Section 159GZZQ(2) – 1936 Tax Act