

# THE ROLE OF BUSINESS SUCCESSION AGREEMENTS

The primary role of a Business Succession Agreement is to regulate the sale and purchase of a Business Person's Equity in a Business when an insured event occurs and the insurance proceeds fund the agreed Purchase Price.

Traditionally, there have been very basic provisions dealing with this issue in standard Shareholders Agreements and Partnership Agreements.

However, the introduction of Capital Gains Tax resulted in potential tax liabilities for all forms of Business Insurance (including Buy/Sell Insurance) under the Income Tax Assessment Act 1997 and earlier legislation.

As a result, it is now common practice to prepare a dedicated Business Succession Agreement, in order to minimise the Capital Gains Tax liabilities. These liabilities are often not addressed in standard Shareholders Agreements and Partnership Agreements.

## Solving the Capital Gains Tax Problem

The underlying Capital Gains Tax problem is that insurance proceeds are taxed differently according to:

- the insured event that gives rise to the claim; and
- the owner of the Policy.

The Insured Events fall into two categories:

- Death Benefits; and
- Non-Death Benefits (such as Total and Permanent Disablement, Trauma and Terminal Illness Benefits).

Care must be taken to ensure that the method of ownership does not incur an unnecessary Capital Gains Tax liability.

### “Death Benefits”:

Under Section 118-300, Death Benefits will only be exempt from CGT, if the Owner of the Policy is any person or entity that:

- is the “original beneficial owner” of the Policy; or
- did not give any consideration for the acquisition of the Policy.

### “Non-Death Benefits”:

Under Section 118-37, Non-Death Benefits (such as Total and Permanent Disablement, Trauma and Terminal Illness Benefits) will only be exempt from CGT, if the Owner of the Policy is:

- The Life Insured (**“Self-Ownership”**); or
- The Trustee of an Insurance Trust under which the Life Insured is “absolutely entitled” against the Trustee under Section 106-50 (**“Trust Ownership”**).

The Non-Death exemption is limited to direct or indirect Self-Ownership and is therefore much narrower than the Death exemption.

## Implications for Buy/Sell Cover

Because Non-Death Benefits are usually bundled with a Death Benefit under the one Policy, the normal method of ownership of all Buy/Sell Insurance is now Self-Ownership or Trust Ownership.

It is no longer normal for the Business or the Purchasers to own Buy/Sell Insurance (**“Cross-Ownership”**), because of the CGT liability with respect to Non-Death Benefits.

## Implications for Debt Reduction Cover

Debt Reduction Cover has traditionally been owned by the Company or Business. However, this method of ownership will now result in a CGT liability in the case of Non-Death Benefits.

Unfortunately, while the receipt of Death Benefits by a Company would be CGT-free, there would be no franking credits. Therefore, any subsequent dividends would be taxable at the full marginal rate of the shareholders.

The CGT liability of the Non-Death Benefits and the income tax liability of subsequent dividends attributable to the Death Benefits can both be avoided by the use of a Business Insurance Trust Agreement.

Businesses can use this component of a Business Insurance Trust Agreement, even if no Buy/Sell Cover is required.