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## Business Succession Planning: Part 2

### Introduction

In our last review we introduced Business Succession Planning, and in particular Buy Sell Agreements and how insurance can be used to fund them. In this edition we cover policy ownership - a critical issue with significant financial implications.

### Policy Ownership - Self Owned v Cross-Owned v Company-Owned

There is some confusion in the industry over this one but there shouldn't be. Self-ownership is the preferred option for a number of reasons.

If a partner dies for example, and he has self-owned policies, his estate receives the insurance proceeds, tax free. With a Buy Sell agreement in place, his share in the business then transfers to the remaining partner(s). Clean and simple.

A number of problems could arise however if the policies had been cross-owned or company-owned. For example, TPD or Trauma policy proceeds would be taxed as a capital gain in the policy owner's hands, unless they were a "defined" relative (Income Tax Assessment Act 1997). Timing may also be an issue - if the business partner were to receive the funds there could be a time delay before they paid the money across, at a time the family probably needs it most.

Self-owned policies also reduce the risk of a bankruptcy or insolvency soaking up the insurance. With cross-owned or company-owned policies there is always a risk that if the other partner is bankrupt or the business is insolvent at the time, the proceeds would be directed straight to creditors and the estate or partner could miss out.

Cross-owned policies also become complicated when there are more than 2 partners and with company-owned policies issues, such as anti-streaming rules and share buy-back regulations also act as disincentives.

### Policy Ownership - Bare Trust-Owned

Bare trust ownership is another option although this needs to be treated with caution. This is where a special purpose trust is established to own the insurance policies, with the trustee's only duty being to pass on the assets to the appropriate beneficiaries.

These are particularly popular where there are 4 or more partners, and there is a chance one or more will depart and others join. These changes are managed via a register attached to the bare trust, where the change in owners and policies can be noted. This avoids the need for a new Buy Sell Agreement each time a change in owners occurs.

Bare trusts also offer the opportunity to cut costs as the policies are combined under one owner, thus reducing policy fees.

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If properly drafted, Bare trusts do not attract Capital Gains Tax, however it's critical to ensure that the trustee performs no other duty other than pass on the insurance proceeds to the appropriate beneficiaries, otherwise CGT will be payable on any proceeds.

Note that whilst the Bare trust can be set up appropriately, it is in administering the trust that the client needs to be absolutely sure they do not transgress the "no other duties" rule.

### Policy Ownership - Super Fund Owned

What about a Super Fund owning the policies? This is possible but only under limited circumstances.

The first concern is possible non-compliance - insurance established to fund a business buy-out may not be seen as consistent with funds being used to provide for retirement or financial dependants.

There have been Tax Rulings that indicate Life and TPD insurance may be deductible without making the fund non-compliant however this has not been enshrined in legislation. (Trauma insurance is not deductible for a Super Fund under any circumstances.)

Other issues to be considered include:

- whether the insurance will push the fund balance over the RBL

limit.

- family circumstances ie insurance funded death benefits paid to non-dependants will be taxed at 31.5%. TPD payments paid out by the fund will be taxed as ETP's.
- a self-employed person receiving a TPD payment will not be eligible for the invalidity component.
- an "Own Occupation" TPD payout may not be available until retirement age.

### Combining personal and business needs?

With a properly drafted Buy Sell Agreement, you can combine insurance cover for business and personal needs under the one policy which reduces the cost to the client. To avoid unnecessary CGT, the Buy Sell Agreement needs to identify the different uses for the insurance so that CGT is not payable on the entire amount (ie its applicable to the higher of contract amount or market value).

### More information?

If you would like a copy of our 16 Dangerously Common & Costly Business Succession Planning Traps please email us on [info@irongroup.com](mailto:info@irongroup.com).