

# irongroup lawyers



August 2005

## Business Succession Planning and Tax Issues

### Introduction

Tax implications seem to be a key area of concern for many Advisers moving into the Business Succession Planning area. However whilst it may appear complex at first glance, it's not if you follow some basic guidelines.

### Two key elements

When preparing an insurance plan for clients you need to consider 2 key elements for tax purposes. The first is the tax implications associated with the insurance itself ie Are the premiums deductible? Are any claims received considered as revenue or a capital gain and therefore taxable?

Second, the tax implications around the transfer of the shares or units in the business which occurs if the Buy Sell Agreement is triggered ie when a business (or a share in it) is sold or changes hands, the seller may make a capital gain which may be taxable.

### 1. Tax on Insurance premiums and proceeds

#### 1. Life Policies

**Income Tax** - Premiums on life policies taken out to fund a Buy Sell agreement are not deductible, nor are the proceeds taxable as income, as the purpose is to pay out a capital sum.

**Capital Gains Tax** - Is CGT payable on a life policy used to fund a Buy Sell agreement? Under the Income Tax Assessment Act 1997 Section 118-300, a capital gain you make from the proceeds of a life insurance policy is disregarded if you are...

1. The original beneficial owner of the policy or
2. You acquired the policy for no consideration or
3. You are a trustee of a complying super fund

So what is defined as a Life insurance policy? Under Section 995-1, life insurance is defined as a policy on the life of an individual ie it does not include TPD or trauma.

So life policies for Business Succession purposes do not attract CGT.

#### 2. TPD & Trauma Policies

**Income Tax** - Premiums on TPD and Trauma policies taken out to fund a Buy Sell agreement are not deductible, nor are proceeds assessable for income tax, again as the purpose is to pay out a capital sum.

**Capital Gains Tax** - Is CGT payable? That depends who owns the policy. Under the Income Tax Assessment Act

# Business Succession Planning and Tax Issues

1997 Section 118-37, "...a capital gain you make is disregarded if ... the compensation or damages you receive is for any injury or illness you or your relative suffers personally."

This has serious implications for 3rd party ownership of any trauma or TPD policies.

If someone other than the insured or their relative receives insurance proceeds it will be considered as a capital gain.

When TPD or trauma policies are self-owned, there is clearly no issue, however if they are cross-owned (which we strongly advise against for a range of reasons) CGT will be payable.

## 2. Tax on Transfer of Assets

The second element of tax to be considered is on the transfer of the assets ie if one partner dies or suffers a TPD or trauma incident and the agreement is triggered.

When shares or units change hands as a result of the Buy Sell Agreement, CGT may be applicable if the owner has made a capital gain.

Who pays it? It is payable by the partner handing over their shares ie the departing partner, not the one receiving them.

By way of example, let's say John & Chris started a business (a company) the shares in which are owned equally by their individual companies. It's now worth \$1m and they have a Buy Sell Agreement.

John suffers a stroke and receives his insurance proceeds. His shares are transferred to Chris' company as per the Agreement. John's company is then liable for CGT on \$500K which is \$150K ie 30%.

In this instance their Adviser correctly allowed for an additional \$150K of insurance for CGT so John has not only received an adequate sum for his share in the business, he also has enough to pay the tax.

## What could have gone wrong?

If that policy had been cross-owned, as insurance proceeds it would have been taxed for CGT in Chris' hands before he handed it over to John ie he would have been liable for \$195K in CGT ie  $\$650K \times 30\% = \$195K$  tax, leaving \$455K.

That would have meant only \$455K was available for John who would still need \$650K as he is still liable for CGT on the share transfer.

In all, an expensive mistake which was avoidable.

## Key Learnings...

In addition to CGT, there are a number of complications around cross-owned and company owned policies. All policies used to fund Buy Sell Agreements should be self-owned where possible.

If it's a company or trust that owns the interest in the business entity add 30% for CGT. That's the maximum that will be payable - if there's any left over as a result of CGT concessions, it can be used for personal reasons.

## More information?

For a copy of our Adviser Insight on Business Succession Planning email us on [info@irongroup.com](mailto:info@irongroup.com) or check our website [www.irongroup.com](http://www.irongroup.com)

If you have a query or would like help with a business succession plan please call one of our lawyers on 03 8621 9000. We'd be pleased to help.