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Business succession – The current state of play

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1 Introduction

It is important for all businesses to have a succession plan or exit strategy for its owners.

There are a number of factors that need to be considered in determining the best exit strategy for business owners including: what industry does the business operate in? is there more than one principal? can the business operate independently of the principals? what type of purchaser would offer the principals maximum value for the business? etc.

Some possible exit options include:

- engaging in a competitive sale process through the assistance of a corporate advisor or business broker. This may ultimately result in:
    - offering the business to the market at large or a select group of targeted buyers;
    - a sale to a private equity / venture capital fund; or
    - a sale to a competitor;
- selling the business to existing employees including through a management buyout; or
- listing through an initial public offering or back-door listing.

A Buy-Sell Agreement can be a very important succession planning tool when used in the appropriate circumstances.

Broadly, a Buy-Sell Agreement is a document that deals with the transfer of ownership interests between one or more existing owners of a business on the occurrence of one or more specified events – often referred to as 'trigger events'.

They are:

- most appropriate where a business is owned by two or more principals that are actively involved in the business; and
- useful in providing business owners and their estates with certainty around what will occur with their ownership interests if an unexpected event occurs in relation to one of the principals.

This certainty is desirable:

- from the perspective of the continuing principals, in knowing that they will be able to acquire the interests of an outgoing principal, avoiding the situation of being left with:
    - a business partner that is no longer able to contribute or the business; or
    - a business partner's estate, who the continuing partners may not wish to have an ongoing relationship with and/or who may not possess the necessary skills to contribute to the business; and

- from the perspective of the exiting principal or their estate, as they have certainty that they will be able to 'cash out' of the business at a pre-determined price or valuation methodology.

Buy-Sell Agreements can be used for a range of business structures, including where a business is structured through a company, unit trust or partnership. However, Buy-Sell Agreements cannot be used where a business is structured through a discretionary trust.

There are a number of ways that a Buy-Sell Agreement can be structured - there is no 'one size fits all model'. This paper explores some of the common structures used in Buy-Sell Agreements and highlights some of the taxation and commercial considerations that arise in each.

Preparing a Buy-Sell Agreement involves the input of a number of advisors. This can typically include:

- the business' accountants who understand the business' finances;

- one or more sets of lawyers. A lawyer needs to prepare the Buy-Sell Agreement. Separate lawyers may also be required to represent each of the business owners as well as to represent the relevant company or unit trust; and

- a financial planner or insurance broker to arrange insurance (for Buy-Sell Agreements funded through insurance).

The author would like to acknowledge the assistance of Ben Markowski in preparing this paper.

2 Key elements of a Buy-Sell Agreement

Set out below are some of the key elements of a Buy-Sell Agreement that must be agreed between the business owners.

2.1 Trigger events

As noted in the introduction, a Buy-Sell Agreement is a document that provides for the transfer of business interests of a business owner to the other business owners on the occurrence of a 'trigger event'.

Buy-Sell Agreements will invariably include death of a business principal as a trigger event.

It is also common for trigger events to include total and permanent disability ('**TPD**') and trauma.

Death, TPD and trauma are each generally insurable. However, the taxation consequences of receiving insurance proceeds from each of these trigger events can differ. This is explained further below.

Other possible trigger events can include bankruptcy or insolvency of a principal or their ownership entity or the divorce, retirement or dismissal of a principal. Inclusion of these types of trigger events is less common and these events are generally not insurable. In the author's experience, it is more common for these types of events to be dealt with in the following documents rather than in a Buy-Sell Agreement:

- *where the business is operated by a company*: the company's constitution or shareholders' agreement;
- *where the business is operated by a unit trust*: the relevant unit trust deed or unitholders' agreement; and
- *where the business is operated by a partnership,* the partnership agreement.

2.2 Price

A critical and sometimes contentious commercial issue that parties to a Buy-Sell Agreement must agree is the value at which an outgoing owner's interests will be transferred under the Buy-Sell Agreement.

It is common for Buy-Sell Agreements to provide for the outgoing owners' interests to be transferred at market value. The following is noted about this approach:

- some business owners prefer for the Buy-Sell Agreement to require the parties to agree a value at the time of the trigger event, and, failing agreement within a prescribed period for the value to be determined by an external valuer or through some other process;

- it is possible to pre-agree a valuer or valuers in the Buy-Sell Agreement, or include a process for selecting a valuer (such as approaching the current Chair of the Resolution Institute to nominate a valuer);
- some agreements will provide for the business' accountant to perform the valuation, or require the averaging of two or more valuations;
- some agreements will include the basis on which market value must be determined, such as future maintainable earnings, discounted cash flows, multiple of EBITDA (sometimes with a pre-agreed multiple), net tangible asset value, etc.;
- some agreements will also include rules for performing the valuation (in addition to the valuation method to be used). Examples of these sorts of rules include:
  - a prescribed discount for a minority ownership interest, or a rule that no discount is to be applied for minority interests; and
  - whether a premium should be added for an interest that provides a purchaser with 'control', or whether no premium should be added in these circumstances.

Other examples of how the price payable for an outgoing owners' interest can be determined under a Buy-Sell Agreement include:

- an agreement that the parties will determine a value for the business on a periodic basis (eg. annually). Where this approach is adopted it is not uncommon for the Buy-Sell Agreement to require the parties to record the value in a schedule to the agreement; and
- where the Buy-Sell Agreement is to be funded through insurance, the quantum of the insurance proceeds.

2.3 Finance

It is common for Buy-Sell Agreements to provide for an outgoing owner's ownership interests to be acquired by the continuing owners. It is also not uncommon for a Buy-Sell Agreement to provide for an outgoing owner's ownership interests to be acquired by the relevant business owning entity (i.e. the company or unit trust that conducts the business – this will be referred to as the '**Business Structure**'). These two approaches are discussed at length below. The relevant acquirer (i.e. the continuing owners or the Business Structure) will be referred to as the '**Purchaser**'.

An outgoing owner will need to be paid the purchase price for their ownership interests by the Purchaser.

A common way to fund the purchase price is for the Buy-Sell Agreement to require insurance policies to be taken out. Where a Buy-Sell Agreement is to be funded through insurance, the following questions arise:

- Who should own the policy?
- Who should be the policy beneficiary?

- Who should pay for the policy premium?
- What should the policy value be?

These issues are discussed below.

It is also possible to have an unfunded Buy-Sell Agreement. In this case the Purchaser will need to finance the purchase price using their own means. This may include:

- an agreement for the outgoing owner to provide vendor finance;
- the relevant Purchaser borrowing against the assets of the Business Structure. Note that where this is done the Purchaser should ensure that it complies with the financial assistance provisions of the *Corporations Act 2001* (Cth) ('**Corporations Act**');[1] or
- where the relevant Purchaser is the continuing owners, borrowing against the continuing owners' personal assets.

2.4 Put and call option vs mandatory agreement

In the author's experience, it is most common for Buy-Sell Agreements to be drafted as put and call options, rather than mandatory agreements requiring owners to transfer their interests upon the occurrence of a trigger event ('**mandatory agreements**').

A put option is a contractual right that permits (but does not require) a seller to compel the buyer to purchase the property that is the subject of the option. That is, the seller can 'put' the relevant asset to the buyer for the buyer to purchase. Conversely, a call option is a contractual right that permits (but does not require) a buyer to compel the seller to sell to the buyer the property that is the subject of the option. That is, the buyer can 'call' on the seller to transfer the relevant property to the buyer.

Where a Buy-Sell Agreement is structured as a put and call option, then upon the occurrence of a trigger event:

- the outgoing owner has the right (but is not obliged) to require the relevant Purchasers to acquire the outgoing owners' interests in the Business Structure – the '**put option**'; and
- the Purchasers have the right (but are not obliged) to require the outgoing owner to sell the outgoing owners' interests in the Business Structure to the Purchaser – the '**call option**'.

This is distinguished from a mandatory agreement under which outgoing owner is *required* to transfer their interests in the Business Structure to the Purchaser upon the occurrence of a trigger event.

From a taxation perspective, the fundamental issue with a mandatory agreement is that the outgoing owner may be treated as having disposed of their interests at the time that they enter into the Buy-Sell Agreement, rather than when the relevant trigger event occurs. Whether the relevant taxing point is at the time the owners enter into the Buy-Sell Agreement or when the trigger event occurs, turns on whether the relevant trigger events are conditions precedent to the formation of the agreement or

[1] Section 260A of the *Corporations Act 2001* (Cth).

conditions precedent to performance of the agreement. Where a condition precedent is a condition precedent to the performance of the agreement, the parties are not obliged to perform their obligations under the agreement until the condition is fulfilled. However, the agreement still exists, and the parties are still bound by it. This is contrasted with a condition precedent to formation where the agreement is only formed and the parties are only bound by the agreement once the condition is fulfilled.

The ATO has documented its views on this issue (see, for example, ATO ID 2003/128 and ATO ID 2004/668).

It is clear from the authority that in the absence of a clear intention for a condition precedent to be a condition to formation, a condition will generally be treated as a condition precedent to performance rather than a condition precedent to a formation. Accordingly, great care needs to be taken in preparing a Buy-Sell Agreement structured as a mandatory agreement to ensure that the trigger events are drafted as conditions precedent to formation.

Another associated issue with mandatory agreements is that there can be difficulty in applying the 50% CGT general discount. This difficulty arises if the relevant trigger events are treated as conditions precedent to performance. In these circumstances, twelve months would need to pass from the time that the owners acquire their ownership interests and the time the owners enter into the Buy-Sell Agreement, rather than the time between acquiring their ownership interests and the occurrence of the relevant trigger event.[2]

It is because of these potential issues and uncertainty that it is preferable and most common for Buy-Sell Agreements to be structured as put and call options. Where a Buy-Sell Agreement is structured as a put and call option, the occurrence of a trigger event allows the outgoing owner or Purchaser to then exercise their respective put or call option, enabling the transfer to occur.

As an aside, irrespective of whether a Buy-Sell Agreement is structured as a mandatory agreement or put and call option, the agreement should set out the terms on which the outgoing owner's interests will be transferred. Including certainty around these issues reduces the risk that the Buy-Sell Agreement will be set aside for uncertainty. These terms can include:

- the relevant completion date (for example 30 or 60 days after the relevant put or call option is exercised);
- a requirement that the interests be transferred unencumbered; and
- basic warranties (for example that the outgoing owner has title to the interests, has the required capacity to perform its obligations under the agreement and is not insolvent).

It is not uncommon where a Buy-Sell Agreement is drafted as a put and call option for the Buy-Sell Agreement to annex a form of sale agreement for the parties to enter into once one of the options is exercised. There are benefits in preparing the agreement on this basis rather than the alternative of including the relevant sale terms in the body of the Buy-Sell Agreement itself.

[2] Or put or call option is exercised as the case may be.

3 Common structures for Buy-Sell Agreements

In the author's experience, the following options (or variations of them) are the most common ways in which Buy-Sell Agreements can be structured:

- **Option 1: Continuing Owners as purchasers: Own Policy**

  Under this option, the Buy-Sell Agreement provides for the outgoing owner's interests to be transferred to the continuing owners (generally pari passu) on the occurrence of a trigger event.

  Under this option:

  - each principal would maintain a life insurance policy over their own life; and
  - the purchase price payable by the continuing owners for the outgoing owner's interest would generally by determined as the greater of **A** & **B** where:

    A = A nominal sum (for example $1.00); and

    B = ***PP – X***

    Where:

    PP = the market value of the outgoing owner's interests; and

    X = the insurance proceeds received by the outgoing owner.

- **Option 2: Continuing Owners as purchasers: Cross-Insurance**

  This option is the same as the above, however the life insurance policies over each principal are held by the other principals.

- **Option 3: Business Structure as purchaser**

  Under this option, the Buy-Sell Agreement provides for the Business Structure (i.e. the company or unit trust that conducts the business) to acquire the outgoing owner's interests on the occurrence of a trigger event.

  Where this option is insurance funded, the Business Structure would hold the relevant insurance policies.

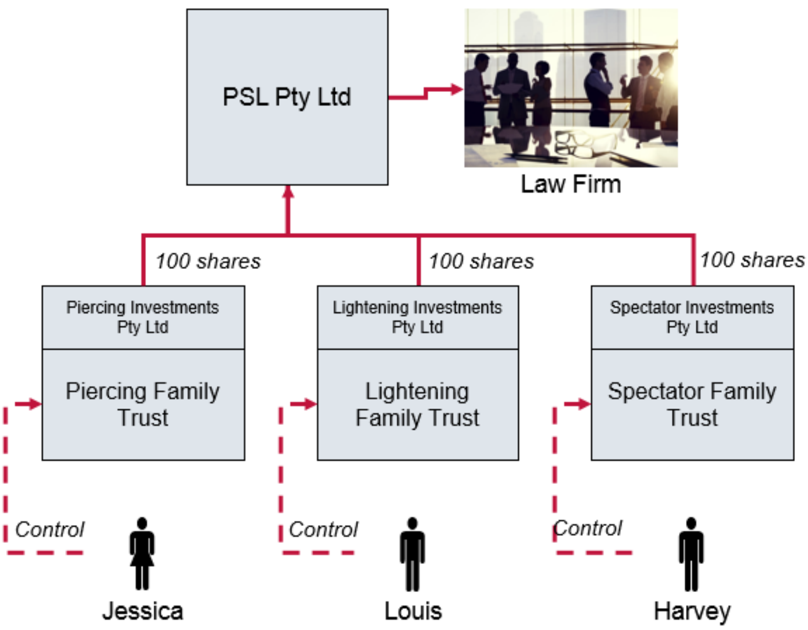
- **Option 4: Insurance Trust model**

  A special purpose trust is established to hold policies over the lives of each of the business owners. Proceeds are then distributed from the trust in one of the following ways:

  - to the continuing parties to assist them to acquire the outgoings owner's interest; or
  - to the outgoing owner, who, upon receipt, transfers their ownership interests to the continuing owners for a purchase price calculated in the same manner as under Option 1 (see above).

Sections 4, 5, 6 and 7 below explore each of the above options in greater detail. These sections illustrate the various models using the following factual scenario:

- PSL Pty Ltd (‘**Company**’) is an Australian incorporated legal practice, providing commercial legal services to clients based in Australia and around the world.
- The Company was incorporated in 1995.
- The three legal principals of the Company are Jessica, Harvey and Louis.
- The shares on issue in the Company are held as follows:
  - 100 shares: Piercing Investments Pty Ltd as trustee for the Piercing Family Trust (‘**Jessica’s Trust**’). This trust is controlled by Jessica. Jessica and Jessica’s Trust will be referred to collectively as the ‘**Jessica Group**’.
  - 100 shares: Spectator Investments Pty Ltd as trustee for the Spectator Family Trust (‘**Harvey’s Trust**’). This trust is controlled by Harvey. Harvey and Harvey’s Trust will be referred to collectively as the ‘**Harvey Group**’.
  - 100 shares: Lightening Investments Pty Ltd as trustee for the Lightening Family Trust (‘**Louis’ Trust**’). This trust is controlled by Louis. Louis and Louis’ Trust will be referred to collectively as the ‘**Louis Group**’.
- The market value of the shares held by each of the Jessica Group, the Harvey Group and the Louis Group is $1 million each (i.e. the Company has a market value of $3 million).
- The Jessica Group, the Harvey Group and the Louis Group are all party to a Buy-Sell Agreement.
- The above structure is illustrated diagrammatically below:



4 Continuing Owners as purchasers: Own Policy

4.1 Introduction

As noted above, a Buy-Sell Agreement structured in this way involves:

- the outgoing owner's interests being acquired by the continuing owners; and
- each of the owners maintaining their own insurance policy (which may cover death, TPD and trauma) over themselves;[3] and
- the Buy-Sell Agreement requiring the outgoing owner to transfer their interests for an amount equal to market value less the quantum of insurance proceeds received.[4]

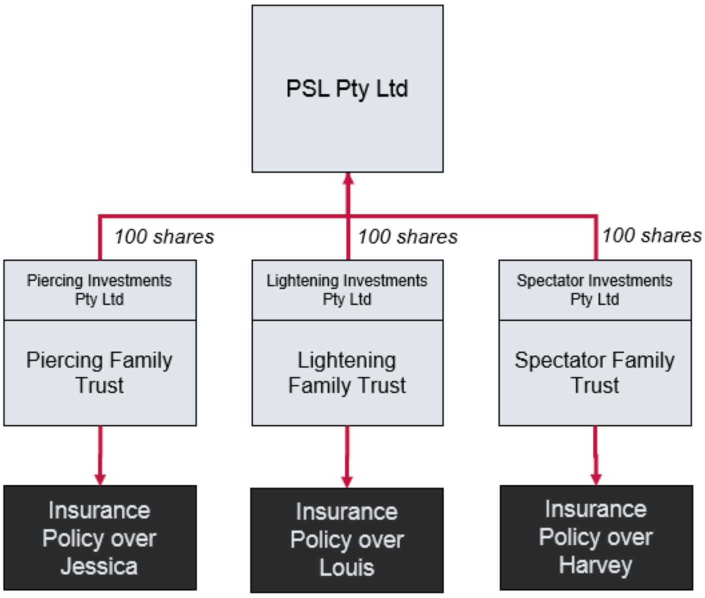
Continuing on from the factual scenario described in section 3 (above), now assume:

- Jessica's Trust holds a life, TPD and trauma event policy over Jessica with an insured amount of $800,000;
- Harvey's Trust holds a life, TPD and trauma event policy over Harvey with an insured amount of $800,000;
- Louis' Trust holds a life, TPD and trauma event policy over Louis with an insured amount of $800,000;
- the relevant Buy-Sell Agreement is structured with put and call options and has three trigger events, namely death, TPD and trauma;
- Harvey is unexpectedly killed when he is run over by a 1968 Ferrari GTB/4; and
- The Jessica Group and the Louis Group execute the call option under the Buy-Sell Agreement to acquire the Harvey Group's shares in the Company for their market value of $1 million.
- The above structure is illustrated diagrammatically below:

[3] Where natural person principals hold their shares through a trust the insurance policy can either be held by the natural person or their trust.

[4] As an alternative the Buy-Sell Agreement could provide that:

- the outgoing owner is required to transfer their shares for market value; but
- the Buy-Sell Agreement provides that the outgoing owner receives the insurance proceeds paid under their policy on trust for the continuing owners who must apply those funds to acquire the ownership interests of the outgoing owner.



4.2 Taxation implications for the Company

Neither entry into the Buy-Sell Agreement nor execution of the call option should give rise to any tax implications for the Company.

4.3 Taxation implications for the Harvey Group

In analysing the taxation implications for the Harvey Group, it is necessary to consider both:

- the tax implications associated with the receipt of the insurance proceeds; and
- any tax implications associated with the disposal of shares in the Company by Harvey's Trust.

4.3.1 Insurance proceeds

In considering the taxation implications associated with the receipt of insurance proceeds by Harvey's Trust, it is necessary to consider section 118-300 of the *Income Tax Assessment Act 1997* (Cth) ('**1997 Act**'). Broadly, this section provides that a taxpayer disregards any capital gain or capital loss that it makes in relation to a CGT asset that is its interest in rights under a life insurance policy where the CGT event happens in relation to the insurance policy and:

- the taxpayer is the original owner of the policy[5]; or
- the taxpayer acquired the interest in the policy for nil consideration[6].

[5] See Item 3 in the table in section 118-300(1) of the 1997 Act.
[6] See Item 4 in the table in section 118-300(1) of the 1997 Act.

It is clear from the above that in order to obtain the benefit of this exemption, the policy owner must be the 'original owner' or have acquired the policy for nil consideration. The term 'original owner' is not defined. However, one would assume that it is a reference to the person who originally took out the policy.

On the present facts, it is likely that any proceeds received by Harvey's Trust from the insurance policy held by Harvey's Trust should be exempt from capital gains tax under section 118-300 of the 1997 Act.

However, the analysis would be different if the relevant trigger event had been TPD or trauma rather than death. Where the relevant insurance proceeds relate to TPD or trauma, it is necessary to consider section 118-37 of the 1997 Act. Broadly, this section provides that any capital gain or loss that a taxpayer derives relating to compensation or damages for any wrong, injury or illness to the taxpayer or their 'relative' will be disregarded for CGT purposes. A 'relative' of a person is defined in section 995-1 of the 1997 Act, and means:

- the person's spouse;
- a parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of the person or the person's spouse; or
- the spouse of any person referred to in the above bullet point.

As is the case in the current factual scenario, it is common for principals to hold investments through a family trust. Where the relevant insurance policy is held by the business owner's family trust and the family trust pays the proceeds to the person that is the subject of the insurance (or one of their relatives), then the proceeds will also be exempt in the hands of the subject (or their relative as the case may be). So, on the present facts, the insurance proceeds should be exempt both in the hands of Harvey's Trust and Harvey/Harvey's estate.

The major takeaway from the above is that a payout for TPD or trauma will only be exempt if it is ultimately received by the injured party or their relative. This can cause issues with cross owned policies (see section 5 below).

4.3.2 Disposal of shares in the Company

The transfer of shares from Harvey's Trust to Jessica's Trust and Louis' Trust pursuant to the Buy-Sell Agreement will trigger a CGT event A1 for Harvey's Trust.[7] Harvey's Trust will make a capital gain to the extent that the capital proceeds received from the disposal exceeds its cost base in the shares.

We are told that the relevant Buy-Sell Agreement provides that the relevant purchase price payable to Harvey's Trust equals market value of Harvey's Trust's shares less any insurance proceeds received. We are also told that the market value of Harvey's Trust's shares is $1 million and that the insured

[7] Assuming interests were acquired post 20 September 1985.

amount is $800,000, meaning that the price payable by Jessica's Trust and Louis' Trust is $200,000 ($100,000 payable by each).

The question on the present facts is whether Harvey's Trust's capital proceeds will be:

- $1 million (being the market value of the shares being transferred); or
- $200,000.00 (being the actual amount of cash that will be paid by the continuing shareholders).

The answer depends on whether the 'Market Value Substitution Rule' in section 116-30(2)(b) of the 1997 Act applies. This section provides as follows:

Section 116.30: Market value substitution rule: modification 1

…

(2) The capital proceeds from a CGT event are replaced with the market value of the CGT asset that is the subject of the event if:

…

(b) those capital proceeds are more or less than the market value of the asset and:

(i) you and the entity that acquired the asset from you did not deal with each other at arm's length in connection with the event; or

(ii) the CGT event is CGT event C2 (about cancellation, surrender and similar endings).

(The market value is worked out as at the time of the event.)

Market value substitution will apply if it can be shown that the Harvey Group, the Jessica Group and the Louis Group did not deal with each other at arm's length in connection with the disposal. It is well established that parties can for all intents and purposes be arm's length parties, but not deal with each other at arm's length in respect of a particular dealing.

On the present facts, whilst the Harvey Group, the Jessica Group and the Louis Group may deal with each other at arm's length in respect of all other dealings, it is likely that the Commissioner will form the view that they may not be dealing with each other at arm's length with respect to the Buy-Sell Agreement (on the basis that they are agreeing to transfer interests for less than market value due to the insurance policies that are in place). On this basis market value substitution would apply meaning that Harvey's Trust would be deemed to have received capital proceeds of $1 million dollars from the disposal of its shares in the Company.

As noted above, Harvey's Trust would derive a capital gain to the extent that its cost base in its shares is less than the market value of $1 million dollars. Any resulting capital gain may be able to be reduced by applying the 50% general CGT discount as well as potentially accessing the small business CGT concessions.

4.4 Taxation implications for the continuing shareholders

There will be no taxation implications for the Jessica Group or the Louis Group in relation to the insurance proceeds received by the Harvey Group.

The key tax issue for Jessica's Group and Louis' Group is the quantum of cost base they will receive on the shares they acquire from Harvey's Trust.

For the reasons set out above, it is likely that the market value substitution rule will apply to the disposal by Harvey's Trust, resulting in Harvey's Trust being deemed to have received capital proceeds of $1 million in relation to the share transfer. There is a similar market value substitution rule that applies to cost base. This section provides as follows:

SECT 112.20(1)(c): Market value substitution rule

(1) The first element of your * cost base and * reduced cost base of a * CGT asset you * acquire from another entity is its * market value (at the time of acquisition) if:

…

(c) you did not deal at * arm's length with the other entity in connection with the acquisition.

Applying the same logic that was applied above to the application of section 116-30(2)(b)(a) of the 1997 Act in relation to the disposal by Harvey's Trust, it is likely that section 112-20(1)(c) of the 1997 Act will apply to modify the Jessica Group's and the Louis Group's cost bases in the shares they acquire from Harvey's Trust to their market value of $1 million.

5 Continuing Owners as purchasers: Cross-Insurance

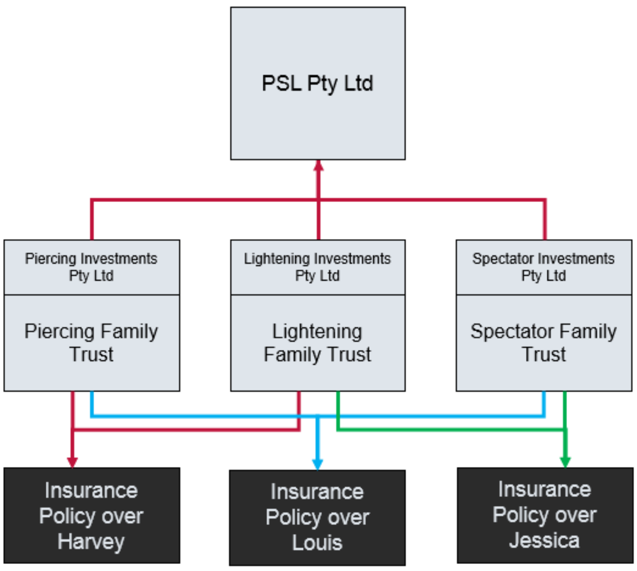
5.1 Introduction

This structure is similar to the structure explained in section 4 (above), however rather than the business owners maintaining their own insurance policies, each business owner holds an interest in an insurance policy over each other business owner (excluding itself).

Buy-Sell Agreements structured in this way will compel the continuing parties that hold the policy over the exiting owner to use the insurance proceeds to acquire the interests of the outgoing owner. Whilst this structure can appear to be logical and intuitive, there are a number of issues with this structure as detailed below.

Continuing on from the factual scenario described in section 3 (above), now assume:

- Jessica's Trust and Louis' Trust hold a life, TPD and trauma event policy over Harvey with an insured amount of $800,000;
- Harvey's Trust and Jessica's Trust hold a life, TPD and trauma event policy over Louis with an insured amount of $800,000;
- Louis' Trust and Harvey's Trust hold a life, TPD and trauma event policy over Jessica with an insured amount of $800,000; and
- Harvey is unexpectedly killed when he is run over by a 1968 Ferrari GTB/4, resulting in Jessica's Trust and Louis' Trust receiving an insurance payout on the policy they jointly hold.
- The above structure is illustrated diagrammatically below:



5.2 Taxation implications for the Company

There are no taxation implications for the Company associated with the payment of insurance proceeds to Jessica's Trust and Louis' Trust or the transfer of shares from Harvey's Trust to Jessica's Trust and Louis' Trust.

5.3 Taxation implications for the Harvey Group

Under a cross insurance structure, the Harvey Group would not receive any insurance proceeds on the death of Harvey.

Harvey's Trust would, however, receive proceeds for the disposal of its shares in the Company. We are told that the relevant purchase price for the shares is based on market value of $1 million. The $1 million would be financed by Jessica's Trust and Louis' Trust through a combination of insurance proceeds and other means.

Again, the transfer of shares from Harvey's Trust to Jessica's Trust and Louis' Trust pursuant to the Buy-Sell Agreement will trigger a CGT event A1 for Harvey's Trust.[8] Harvey's Trust will derive a capital gain to the extent that its cost base in its shares is less than the capital proceeds the trust receives of $1 million dollars. Any resulting capital gain may be able to be reduced by applying the 50% general CGT discount as well as potentially accessing the small business CGT concessions.

5.4 Taxation implications for Louis and Jessica

The two key tax considerations for the Jessica Group and the Louis Group are:

- whether the payment of the insurance proceeds to Jessica's Trust and Louis' Trust will be taxable; and
- whether Jessica's Trust and Louis' Trust will receive market value cost base for the shares they acquire from Harvey's Trust.

In the current factual scenario we are told that the relevant trigger was Harvey's death. The insurance proceeds will be exempt under section 118-300 of the 1997 Act provided that:

- Jessica's Trust and Louis' Trust are the original owners of the policy; or
- Jessica's Trust and Louis' Trust acquired the policy for nil consideration.

A key shortcoming with cross-insurance arises where one of the policy owners retires, resigns or otherwise leaves the business. In these circumstances the outgoing owner may transfer their interest in a cross-insurance policy to continuing owners. In order to help prevent any proceeds paid on that policy being taxable to the recipients, the parties must ensure that the policy is transferred from the

[8] Assuming interests were acquired post 20 September 1985.

outgoing owner to the continuing owners for no consideration. There is a risk that even if a policy is transferred for no consideration, that the acquirer of the interest in the policy is deemed to have acquired the policy for consideration.

Another key issue with cross insured policies is where the relevant trigger event is TPD or trauma. As noted above, proceeds paid on a TPD or trauma policy are only CGT exempt if they fall under the exemption in section 118-37 of the 1997 Act. This section requires that the recipient of the proceeds is the injured person or a 'relative' of the person. It is often unlikely that parties to a Buy-Sell Agreement will be 'relatives' of one another. As a result, it is unlikely that insurance proceeds received on TPD or trauma policy held under a cross-insurance structure will be tax free.

Where Buy-Sell Agreements are structured in this way, the continuing owners are in effect required to acquire the outgoing owners' interest at full market value, but are assisted in financing this acquisition using insurance proceeds. On the basis that full market value is being paid for the outgoing owner's interests (albeit the payment is being wholly or partially funded through insurance), the continuing owners would receive a cost base equal to the amount paid for the shares which, on the present factual scenario would be $1 million.

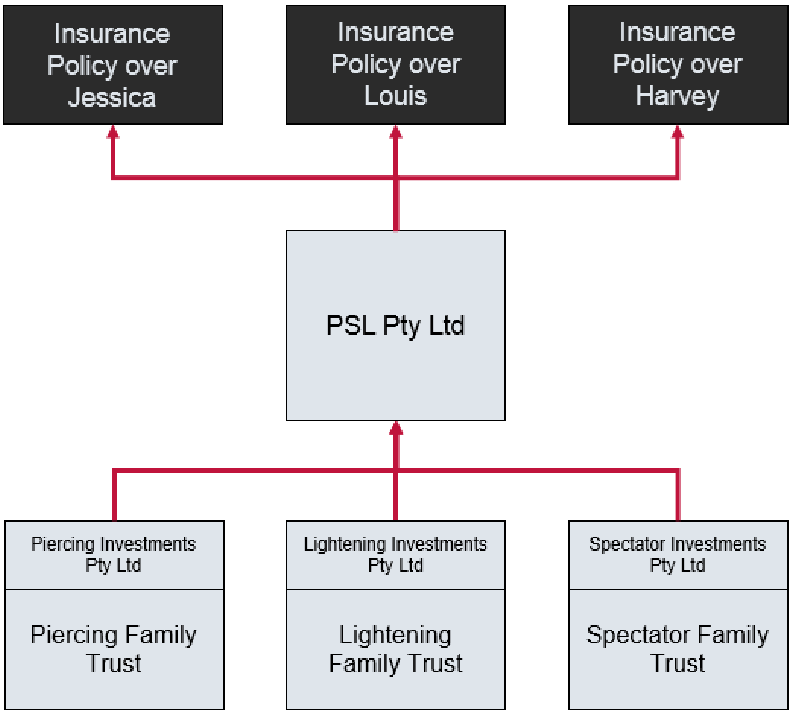
6 Business Structure as purchaser

6.1 Introduction

Another way in which a Buy-Sell Agreement can be structured is by having the relevant Business Structure (being a company or unit trust) acquire the interests of the outgoing owner.

Continuing on from the factual scenario described above, now assume:

- the Company holds life, TPD and trauma event policies over each of Harvey, Jessica and Louis with an insured amount of $800,000 each;
- the Company together with the Harvey Group, Jessica Group and Louis Group are party to the Buy-Sell Agreement;
- Harvey is unexpectedly killed when he is run over by a 1968 Ferrari GTB/4, resulting in the Company receiving an insurance payout on the policy it holds over Harvey; and
- the Company is required under the Buy-Sell Agreement to use the insurance proceeds to acquire the shares held by Harvey's Trust.
- The above structure is illustrated diagrammatically below:



6.2 How will the Company acquire Harvey's Trust's shares?

In order to acquire the shares held by Harvey's Trust, the Company will need to either undertake:

- a share buy-back; or
- a selective capital reduction.

Broadly, a share buy-back is where a shareholder or shareholders sell back their shares to the company. Once the company acquires these shares it will immediately cancel them. There are a number of different categories of share buy-backs. In the context of a Buy-Sell Agreement the relevant category of buy-back will invariably be a selective buy-back, on the basis that the offer will only be made to the outgoing shareholder or their estate.

A selective capital reduction can be used to achieve the same commercial result. This would be achieved by the relevant company cancelling a shareholder's shares in return for repayment of any amount paid to the company in respect of the relevant shares and, in some cases, an additional amount to reflect the market value of the shares being cancelled.

In order for a company to effect a share buy-back: [9]

- the buy-back must not materially prejudice the company's ability to pay its creditors; and
- the company must follow the provisions of Division 2 of Part 2J.1 of the Corporations Act. These provisions require, amongst other things, for the buy-back to be approved by all shareholders, or by a special resolution (requiring a 75% majority) of the shareholders in which no vote is cast by the exiting shareholder or its associates.[10]

Broadly, a company may undertake a selective capital reduction[11] if the reduction:

- is fair and reasonably to the company's shareholders as a whole;
- does not materially prejudice the company's ability to pay its creditors; and
- is approved by shareholders under section 256C of the Corporations Act. In the case of a selective capital reduction the reduction must be approved by either:
  - a special resolution with no votes being cast in favour of the resolution by any person who is to receive consideration as part of the reduction or whose liability to pay amounts unpaid on shares is to be reduced, or by their associates; or
  - a resolution agreed to by all ordinary members.

As noted above, the Corporations Act requires that either a buy-back or selective capital reduction must not materially prejudice the company's creditors. If the company is not in a sound financial position at the time that the relevant trigger event occurs under the Buy-Sell Agreement then the

[9] See s257A of the Corporations Act.
[10] See s257D of the Corporations Act.
[11] See s257B of the Corporations Act.

company may be prevented under the Corporations Act from completing the transaction. This scenario would, of course, be at odds with the purpose of entering into the Buy-Sell Agreement in the first place.

In order for a company to effect a share buy-back or a selective capital reduction, there are procedural requirements under the Corporations Act that must be adhered with. These procedural requirements include the passing of specific resolutions[12] as well as the requirement to lodge certain documents with ASIC.

One of the key differences between a share buy-back and a selective capital reduction is the taxation implications for the shareholder whose shares are the subject of the buy-back or capital reduction. This is discussed further below.

6.3 Taxation implications for the Company

The Company will receive a payout on the insurance policy it holds over Harvey's life. The insurance proceeds will be exempt under section 118-300 of the 1997 Act provided that:

- the Company is the original owner of the policy; or
- the Company acquired the policy for nil consideration.

However, the relevant tax implications would be different if the relevant trigger event were trauma or TPD rather than death. As noted above, proceeds paid on a TPD or trauma policy are only CGT exempt if they fall under the exemption in section 118-37 of the 1997 Act. This section requires that the recipient of the proceeds is the injured person or a 'relative' of the person. The Company will not be a 'relative' of Harvey for the purposes of this section. Accordingly, the exemption in section 118-37 of the 1997 Act will not apply, meaning that any insurance proceeds received by the Company on the TPD or trauma policy will be taxable to the Company.

6.4 Taxation implications for Harvey's Trust

As noted above, the shares held by Harvey's Trust will either be acquired by the Company through a share buy-back or a selective capital reduction. A high level summary of the taxation consequences of each of these approaches is set out below.

6.4.1 Share buy-back

If the shares held by Harvey's Trust are acquired by way of a share buy-back, then the consideration received by the Harvey's Trust will be divided into a dividend component and a capital component.

In broad terms:

[12] See s257D of the Corporations Act (in relation to share buy-backs) and s256C of the Corporations Act (in relation to capital reductions).

- whether a deemed dividend will arise depends on the manner in which the company accounts for the buy-back;[13]
- the capital component will be the amount that is debited against the Company's share capital account; and
- the dividend component will be the amount of the purchase price in excess of the amount debited to the Company's share capital account.

The Company has some control over the amount determined to be a dividend. PS LA 2007/9 sets out three methods for determining this split that are acceptable to the ATO.

The dividend component of the consideration will be taxable. However, it is worth noting that the dividend component can potentially be franked.

On the assumption that Harvey's Trust is an Australian tax resident, the non-dividend or capital component will be subject to tax under the CGT regime. The buy-back will trigger a CGT Event A1 for Harvey's Trust. Harvey's Trust will make a capital gain to the extent that the capital component exceeds the trust's cost base in the shares. Any resulting capital gain may be able to be reduced by applying the 50% general CGT discount as well as potentially accessing the small business CGT concessions.

In undertaking a share buy-back advisors should be conscious of the various anti-avoidance and integrity measures.[14]

6.4.2 Capital reduction

It is possible for a capital reduction to be done in conjunction with a share cancellation, however this is not mandatory. On the present facts the capital reduction will be done in conjunction with a cancellation of the shares held by Harvey's Trust.

A capital reduction out of a company's share capital without a share cancellation will trigger CGT Event G1 for the shareholder.

In the present case the capital reduction is being undertaken together with a cancellation of the shares held by Harvey's Trust. In this case CGT Event C2 will be triggered. Harvey's Trust will make a capital gain to the extent that the amount of the payment received from the Company exceeds the trust's cost base in the shares. Any resulting capital gain may be able to be reduced by applying the 50% general CGT discount as well as potentially accessing the small business CGT concessions.

Again, in undertaking a capital reduction advisors should be conscious of the various anti-avoidance and integrity measures.[15]

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[13] See s159GZZZP(1) of the *Income Tax Assessment Act 1936* (Cth).
[14] See, for example, sections 45A and 45B of the 1936 Act, Part IVA of the 1936 Act and section 204-30 of the 1997 Act.
[15] See, for example, sections 45A and 45B of the 1936 Act, Part IVA of the 1936 Act and section 204-30 of the 1997 Act.

6.5 Taxation implications for Jessica's Trust and Louis' Trust

The cancellation of the shares held by Harvey's Trust (whether under a share buy-back or capital reduction process) will result in Jessica's Trust and Louis' Trust each increasing the proportion of shares they hold in the Company from one-third to 50%. This is on the basis that Jessica's Trust and Louis' Trust will each go from holding 100 of 300 shares on issue in the Company to holding 100 of 200 shares on issue in the Company.

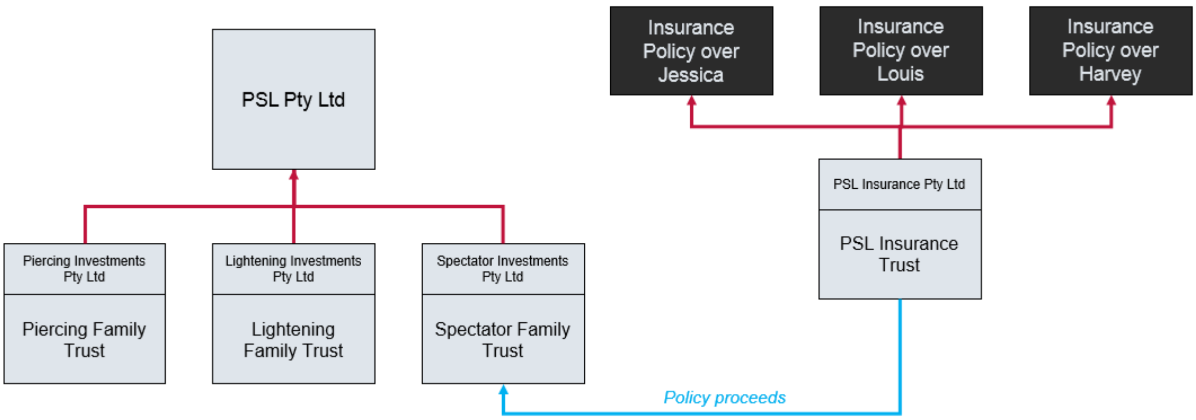
In these circumstances, Jessica's Trust and Louis' Trust will increase their proportionate shareholding in the Company but will not receive an increase in cost base. This is likely to cause a more adverse tax result for Jessica's Trust and Louis' Trust when they ultimately dispose of their shares in the Company than would occur if Jessica's Trust and Louis' Trust had acquired Harvey's Trust's shares under the structures set out in Section 4 and Section 5 above.

7 Trust Model

This model involves the establishment of a special purpose trust to hold insurance policies over each of the principals.

Continuing on from the factual scenario described above, now assume:

- a special purpose trust is established ('**PSL Trust**') to hold insurance policies over each of Jessica, Harvey and Louis. The policies have an insured amount of $800,000 each;
- the Harvey Group, the Jessica Group and the Louis Group have all entered into a Buy-Sell Agreement that provides the continuing proprietors with the right to acquire the outgoing owner's shares in the Company for market value less any insurance proceeds received by the outgoing owner or their estate;
- Harvey is unexpectedly killed when he is run over by a 1968 Ferrari GTB/4, resulting in the PSL Trust receiving an insurance payout on the policy it holds over Harvey;
- the PSL Trust will distribute the proceeds to either Harvey's Trust or to Harvey's estate; and
- the Jessica Group and the Louis Group have exercised their call option to acquire the Harvey Group's shares in the Company.
- The above structure is illustrated diagrammatically below:



In the above example the special purpose trust is a discretionary trust. It is also not uncommon for a fixed trust to be used.

7.1 Taxation implications for the PSL Trust

In the current factual scenario we are told that the relevant trigger was Harvey's death. The insurance proceeds will be exempt under section 118-300 of the 1997 Act provided that:

- the PSL Trust is the original owner of the policy; or

- the PSL Trust acquired the policy for nil consideration.

If the relevant trigger event had been trauma or TPD rather than death, then the insurance proceeds will only be exempt from capital gains tax if one of the exemptions contained in section 118-37 of the 1997 Act applies. On the present facts it is likely that the exemption in section 118-37(b) of the 1997 Act will apply. This section deals with the situation where a trust receives insurance proceeds for any wrong or injury suffered by a beneficiary of the trust or their relative.

7.2 Taxation implications for Harvey

In this example, we are told that the PSL Trust will distribute the insurance proceeds to Harvey's Trust or to Harvey's estate. Either way, we would expect these proceeds to be exempt from capital gains tax under section 118-300 of the 1997 Act.

If the relevant trigger event had been trauma or TPD rather than death, then whether the insurance proceeds are taxable to Harvey or Harvey's Trust depends on whether any of the exemptions contained in section 118-37 of the 1997 Act applies. If the PSL Trust pays the insurance proceeds directly to Harvey then it is likely that these proceeds will not be taxable to Harvey by virtue of section 118-37(ba) of the 1997 Act. If the proceeds are paid via Harvey's Trust, then those proceeds may be exempt under section 118-37(b) of the 1997 Act, however this is less clear.

Under the Buy-Sell Agreement, Harvey's Trust is required to transfer its shares in the Company for market value less the amount of any insurance proceeds received from the PSL Trust. On the basis that:

- the shares held by Harvey's Trust have a market value of $1 million;
- the PSL Trust distributes the insurance proceeds its receives of $800,000 to Harvey's Trust,

then Harvey's Trust will receive a total of $200,000 from Jessica's Trust and Louis' Trust for the shares.

For the reasons set out in section 4.3.2 above, it is likely that the market value substation rule will apply, meaning that Harvey's Trust will be deemed to have received capital proceeds of $1 million dollars from the disposal of its shares in the Company.

As noted above, the Harvey Group would derive a capital gain to the extent that its cost base in its shares is less than the deemed capital proceeds of $1 million dollars. Any resulting capital gain may be able to be reduced by applying the 50% general CGT discount as well as potentially accessing the small business CGT concessions.

7.3 Taxation implications for Jessica's Trust and Louis' Trust

As noted in the section above, the Jessica Group and the Louis Group are entitled to acquire Harvey's Trust's shares with a market value of $1 million for $200,000.

For the reasons set out in section 4.4 above, it is likely that the market value substitution rule will apply to modify the Jessica Group's and the Louis Group's cost bases in the shares they acquire from Harvey's Trust to their market value of $1 million.

8 Other Considerations

8.1 Who should pay for the premium?

One of the key issues with the models set out in Section 4 and Section 5 (above) is determining who should pay for the relevant premiums.

The premiums for death, TPD and trauma insurance will generally not be tax deductible as they are generally on capital account.

If the relevant business is structured through a company and the company pays the insurance premium on the insured's behalf, the payment is likely to give rise to a deemed dividend under Division 7A of the *Income Tax Assessment Act 1936* ('**1936 Act**'). This is on the basis that the insured is the party that is liable for the premium. In order to avoid this, if the company pays the premium it should debit the amount against the shareholders' credit loan account. If this is not possible then the company should not pay the premium.

If the relevant Business Structure pays the insurance premium on the insured's behalf then consideration should also be given to whether any FBT issues arise. It is arguable that even if the shareholder/unitholder (or their associate) is an employee of the Business Structure, the payment of the premium is not subject to FBT on the basis that the payment is not being made in relation to that person's capacity as an employee. Rather, this payment is being made in connection with that person's role as an owner.

8.2 Dealing with loan accounts

It is not uncommon for business owners to have debit and/or credit loan accounts with the relevant Business Structure.

A well drafted Buy-Sell Agreement should deal with what will happen with these loan accounts on the occurrence of a trigger event. This is to ensure that the outgoing owner's exit from the business is as clean as possible.

Buy-Sell Agreements will often include a provision requiring the relevant loan accounts to be repaid at the time of exit.

Another option is for the relevant Buy-Sell Agreement to provide for the relevant loans to be forgiven. This approach can be problematic where the commercial debt forgiveness rules apply.

Where loan accounts are significant, the business owners may wish to consider taking out additional insurance to ensure that the loan repayments can be funded.

8.3 Other observations

The following should be noted when structuring a Buy-Sell Agreement:

- Buy-Sell insurance premiums can often be expensive and, as noted above, are often not tax-deductible. As a result, there can often be a temptation to acquire insurance through superannuation. This paper does not explore the use of superannuation funds to hold Buy-Sell insurance policies in any detail. If this option is attractive to a business owner then specialist advice should be sought. The following general observations are noted regarding the use of superannuation funds to hold Buy-Sell insurance:

    - The premiums paid on certain death or disability policies are potentially tax deductible to the superannuation fund[16]. This applies to superannuation death benefits, terminal medical condition benefits and disability superannuation benefits. These categories are not as broad as death, TPD and trauma.

    - Premiums on trauma policies are unlikely to be deductible.

    - Issues can arise if an insurance policy pays out but the relevant member has not satisfied a condition of release.

    - Proceeds received on a life policy or TPD proceeds are unlikely to be taxable in the fund.[17]

- It is not uncommon for clients to conduct a business through multiple entities or to have ownership interests in a number of different entities. Where this occurs, it is possible in many circumstances for a Buy-Sell Agreement to deal with all of the owner's ownership interests. For example, assume:

    - a group of investors operate a successful business together;

    - each time a new store is opened, the investors establish a new company;

    - the shareholders of each new company are the investors' family trusts;

    - the investors also opened one of their first stores using a unit trust structure. Again, the units are held by the investors' family trusts.

    In this scenario it would be possible for the Buy-Sell Agreement to deal with all of these ownership interests (being the shares in the various companies and units in the unit trust).

- As part of preparing a Buy-Sell Agreement, legal advisors should ensure that the transfers or other transactions provided for in the Buy-Sell Agreement are contemplated in the constituent document governing the relevant Business Structure[18]. So, for example, where the business is conducted through a company and the Buy-Sell Agreement contemplates a transfer of shares from a shareholder who is the subject of a trigger event to the continuing shareholders, the company's constitution and shareholder's agreement (if any) should make provision for this transfer.

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[16] See section 295-460 of the 1997 Act.

[17] See section 118-300 of the 1997 Act, Items 5 and 7 respectively.

[18] In the case of a business operated though a company this will be the company's constitution and shareholders' agreement (if any). For a business conducted through a unit trust this will be the relevant trust deed (as amended) and unitholders' agreement (if any). For a partnership this will be the relevant partnership agreement.

- Where a Buy-Sell Agreement is to be funded through insurance:
  - clients should meet with their insurance broker or financial planner periodically to review their insurance arrangements and ensure that they continue to be adequate;
  - a suitably qualified insurance broker or financial planner should advise on whether a ‘stepped’ or ‘level’ policy is preferable for the client. They should also review the policy for any policy exclusions and to ensure that the policy will pay out if an insured event were to occur.

9 Concluding Remarks

Buy-Sell Agreements can be critical succession planning tools in certain circumstances. They are generally most appropriate for businesses structured through a company, partnership or unit trust where there are multiple owners actively involved in the business. They provide certainty and a clear exit opportunity in circumstances where an unforeseeable event occurs in relation to a business owner such as death, TPD or trauma.

This paper has hopefully:

- highlighted some of the key considerations that business owners and advisors should consider in preparing a Buy-Sell Agreement;
- explained the common ways in which Buy-Sell Agreements can be structured; and
- highlighted some of the key issues and benefits associated with the various models.

In the author's view, there is no 'one size fits all' model for Buy-Sell Agreements. Notwithstanding this, there is often good logic in:

- structuring a Buy-Sell Agreement using put and call options;
- using insurance as the funding mechanism under the Buy-Sell Agreement;
- considering structuring the Buy-Sell Agreement with the continuing owners as purchasers and with each owner holding their own insurance; and
- being careful when using superannuation to hold insurance policies.

In the author's experience, preparing a Buy-Sell Agreement that best suits a client's particular circumstances is a multi-disciplinary effort. It involves assembling a team of suitably qualified and experienced lawyers, accountants and financial planners/insurance brokers that understand the client's objectives, the various structuring options and regulatory constraints.