THE ART OF BUSINESS SUCCESSION

Part five: tax issues in business succession

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TAX ISSUES IN BUSINESS SUCCESSION

One of the significant issues arising for those dealing with business succession is the myriad of taxes that can apply throughout a business succession.

BUSINESS SUCCESSION PLANNING

Businesses run by private groups are complex and one cannot use a text book to determine the best structure and outcome. Where implemented, succession planning needs to be flexible and – like a will – reviewed regularly to take account of changes in the business, and more particularly the regulatory and tax environment. Just consider the taxation changes that have occurred in the last ten years and their impact on privately run businesses and changes to family circumstances!

Business succession planning is a huge topic. The aim in this document is to touch on some of the taxation issues to be considered in either planning for succession, or dealing with succession issues as a result of events which cause a business to cease to operate under its current structure.

BUSINESS SUCCESSION PLANNING

The fundamental idea behind business succession is devising a structure and a predetermined series of steps to allow for the ready passing of assets to dependants or other persons. Apart from the taxation issues, there are asset protection strategies, matters relating to Partnership, Trust and Corporations Law, and ensuring, as far as possible, that the plans do not cause family disputes, either before or after death. There is no simple prescription to be followed in advising clients on these issues, and this guide cannot hope to give all of the answers to enable an estate and/or business succession plan to be implemented. We can only hope to touch the tip of the iceberg. It will however give some useful pointers and will cover matters relating to:

- Funding retirement from a business
- Buy/sell arrangements
- Capital gains issues, and in particular the revamped CGT rules under business tax reform
- Dealing with debts
- Demergers and related techniques
- Tax consolidation.

The business succession plan cannot be considered in isolation. It must be developed in conjunction with the wills of all family members, asset holding and asset protection strategies, and general wealth management and retirement plans.

FUNDING THE EXIT

The options available to owners of privately-owned businesses in planning for exit can involve a combination of scenarios, from use of insurance policies, to external sales of assets in the business itself.
There are a number of matters which one needs to consider when planning for the retirement of a member from a privately-owned business such as:

- The structure and ownership of the assets of the business.
- The desires for the future ownership of the business.
- Desires for future income streams from the business assets.
- The nature and form that retirement benefits could take.

A business succession plan must deal with several possible means of exit from the business which could entail a planned retirement at a predetermined date, or as often happens, going out 'feet first'. This document will deal with the latter scenario.

FUNDING THE EXIT

Consequences of death

Subject to several exceptions, any gain or loss arising on a CGT event in relation to an asset owned by a deceased person is disregarded. The exception relates to assets passing to a beneficiary under the estate that is one of:

- An 'exempt entity' such as a charity
- A complying superannuation fund
- A foreign resident

In such cases, the deceased is deemed to have disposed of, and the beneficiary is deemed to have acquired, the asset immediately before the deceased's death, at its market value. However, any capital gain or capital loss attributed to the deceased is disregarded if the asset was a pre-CGT asset.

Buy/sell agreement

There has been much written about the use of buy/sell agreements. Essentially, they are a mechanism to allow for the funding of an outgoing proprietor's interest, in the case of death or disability. Most commonly, buy/sell arrangements will be implemented for businesses where there are a small number of unrelated proprietors.

Typically, a buy/sell agreement will prescribe that on the death of say, partner A, partner B will pay a predetermined amount for partner A's interest in the business. (Partner, unit-holder and shareholder could be used interchangeably.)

The ATO has confirmed in ATO ID 2004/668 that provided the agreement is drafted in such a fashion that it reflects the proprietors' intention that the agreement does not become binding until some trigger event occurs, (e.g. death), then the condition is a condition precedent to the formation of the contract and is not considered to trigger a CGT event at the time of execution.

Market value substitution

A tax trap with structured funding arrangements is that the proceeds paid on death may not represent the market value of the deceased's interest in the business. The market value substitution rules can substitute market value consideration, despite the agreement between the parties as to the value of the interest.

This represents a major concern for structured funding arrangements. An independent valuation assists in avoiding this market value substitution rule. This would require regular valuations and re-setting of the insurance policy value to account for changes. Different tax issues arise depending upon the ownership of the life insurance policies.

Self-funded insurance

Where the proprietors all hold policies on their own lives, and on death their interests in the business are 'paid out' by the policies, the surviving proprietors pay nothing for the business interests. In this case, the proceeds of the life policy are tax free but the market value substitution rule could apply to the business interests disposed of.

In the case of the remaining proprietors, where they 'pay' nothing for the deceased's interest, they will be deemed to have paid market value for CGT purposes.

FUNDING THE EXIT

Cross-funded insurance

Under a more complex arrangement each proprietor holds a policy on the other proprietor. On death of A, for example, B and C receive proceeds under the insurance policy, which is then paid, under the buy/sell agreement, to A's estate. The proceeds received by B and C are exempt from tax under section 118-300 of the ITAA 1997 and the CGT disposal rules apply to A's estate.

Insurance trusts

Instead of cross ownership or self ownership, an insurance trust is established. It is generally a discretionary trust and may be the owner of life policies, or the recipient of the proceeds of policies. Such proceeds are distributed to the proprietors (or estate) under the terms of the buy/sell agreement.
If the policies are held by the trust, the proceeds will be tax free under section 118-300 as above, and may then be distributed to the remaining proprietors as beneficiaries to allow them to fund the deceased interest.
Generally, it would be expected that the 'conduit' theory, (i.e. trust distributions retain their character on distribution) would apply.
Furthermore, while CGT event E4 can apply to the distribution of non-assessable proceeds to trust beneficiaries, the ATO paper reiterates that CGT event E4 has application to fixed trust beneficiaries and not to discretionary trust beneficiaries.
Alternative insurance trust arrangements, whereby the trust does not own the policies but is the recipient of proceeds, will not gain the section 118-300 exemption.

OTHER FUNDING AND EXIT STRATEGIES

Debt funding

An important part of any business exit is identifying the current and required internal and external debt position. Many businesses will naturally have a combination of internal and external debt, and plans should attempt to ensure that:

- Retiring principals have their debts repaid
- Guarantees and securities given by principals are released
- Debts due by departing principals are repaid, or dealt with so that the private company loan rules (Division 7A) are not triggered. See further discussion below on Division 7A
- If continuing principals are borrowing funds, consideration be given to determining the most appropriate entity for the borrower to secure tax deductions
- Debt/equity issues on existing or proposed funding arrangements are properly considered
- Where a discretionary trust is involved, addressing any unpaid trust distributions.

CAPITAL GAINS TAX

Concessions

The CGT concessions introduced under the Tax Reform measures are very important for business succession. The 50% CGT discount is available to individuals and trusts which crystallise capital gains whilst a 33.3% CGT discount is available to complying superannuation funds.
The Small Business CGT concessions apply to disposals of active business assets and may reduce or eliminate capital gains. Subject to meeting certain conditions, the following concessions may be available:

- A 15 year exemption for certain business assets
- A 50% reduction for active assets of a business, not only for goodwill
- A retirement exemption
- Rollover relief.

These concessions are extremely complex and care must be taken to determine if they are available in a business succession. A detailed analysis of the concessions is beyond the scope of this guide.

SOME SPECIFIC CGT ISSUES

Some particular CGT issues arising on disposal of businesses are highlighted below.

Attributable capital gains

CGT can apply to attribute a taxable gain on disposal of a pre-CGT interest, (i.e. an interest acquired before 20 September 1985), in a company or a trust. Broadly, in the case of shares in a company, where the market value of the post-CGT property of the company is at least equal to 75% of the net value of the company, the shareholder is taken to have made a gain. The amount of the gain is based on the amount reasonably attributable to the unrealised gains inherit in the post-CGT assets of the company.

Pre-CGT assets becoming post-CGT

Changes in ultimate ownership of pre-CGT assets can also trigger CGT consequences. If, as part of a transfer of ownership in shares that occurs under a business succession plan, majority ownership ceases to be maintained, any underlying pre-CGT assets of the company are deemed to be post-CGT, acquired on the date of change for their current market value. There is no immediate tax liability generated.

SOME SPECIFIC CGT ISSUES

Trusts and succession

A particular area of concern with trusts is the possibility of causing a resettlement by amending the terms of the trust, or introducing or removing beneficiaries. The ATO has released a lengthy position paper on this matter regarding when (in the ATO's opinion) a resettlement for CGT purposes can occur. However, the extent of the changes to a trust deed will have to be carefully assessed to see whether a trust is taken to be a new trust. Where a resettlement occurs the original trust ceases to exist and a new trust, (i.e. a new taxpayer/entity) is created. The tax consequences of this creation of a new trust can include:

- The trustee disposes of trust property – with income and capital gains tax consequences – and any un-recouped losses that have been carried forward are lost
- The beneficiaries dispose of their interests in the trust – with income tax and CGT consequences. The beneficiaries acquire interests in the new trust.

Transfer of Control of Trust

A useful technique to transfer an asset within a trust is to transfer control of the trust o the other family member without altering the underlying beneficial owners of the trust. this technique can be useful when there is a family partition and (say) a property within a discretionary trust is to be passed to the daughter. Rather than transfer the actual property, which would attract CGT, stamp duty and possibly GST, the shareholders, directors and appointor of the trust could be changed to the daughter. Done correctly, this could transfer control of the property to the daughter without triggering a CGT or stamp duty liability.

Scrip for scrip

A common exit strategy that is available to departing owners is to sell the shares in the company using a scrip for scrip rollover. Often this sale would be of a listed entity, and the sale proceeds would be in the form of cash and shares. The business owners can then choose to elect to use the scrip for scrip CGT rollover for the share component of the transaction. Subject to any conditions imposed under the sale contract, the shares received in consideration for the sale can then be sold on the market at a time which suits the taxpayer. This could defer the gain until a later income year.
Any cash is treated as ineligible proceeds. There is no rollover for the ineligible proceeds. The cost base of the replacement interest is based on a reasonable allocation of the original interest but is reduced by any ineligible part such as a cash component.
If a pre-CGT interest is exchanged, the replacement interest has a cost base equal to its market value and the replacement shares lose their pre-CGT status.

SOME SPECIFIC CGT ISSUES

Demergers

Commonly, privately-owned businesses will be comprised of several business and asset holding structures, and the desired outcome is to split the business operations and ownership. In the past this outcome would often have generated significant CGT liabilities, however the desired outcome may now be achieved through the use of demergers. The demerger provisions provide for CGT relief. In particular, the shareholders can choose to obtain the rollover where:

- They hold an ownership interest in a company or trust
- That company or trust is the head entity of a demerger group
- A demerger happens to the demerger group
- A CGT event happens to the shareholders' ownership interest
- The shareholders acquire a new or replacement interest in the demerged entity.

A demerger happens to a demerger group if certain conditions are satisfied. The first requirement is that there must be a restructuring of the demerger group. While the mechanism for a demerger is not precisely defined, it might occur by:

- A capital reduction, linked to a transfer or issue of ownership interests in the demerged entity
- Declaration of a demerger dividend
- A combination of these techniques.

The demerger rules provide CGT rollover to owners of a head entity of a demerger group if, under a demerger:

- At least 80% of the demerger group's ownership interests in the demerged entity are acquired by the owners of the head entity
- Each owner receives the same proportion of new interests in the demerged entity as their existing proportion of original interests, just before the demerger, in the head entity
- The market value of the original and the new interests after the demerger is reasonably expected not to be less than the market value of the original interests before the demerger
- The new interests are of a similar kind to the original interests, (i.e. Shares for shares, options for options and units in a trust for units in a trust).

Consequences of rollover and dividend relief

Broadly, the rollover is chosen by the owners of the head entity for each of their affected interests. The effect of the rollover is to defer the crystallisation of a capital gain or capital loss. The cost base of the owners' original interests is then apportioned across the existing interests and new interests acquired under the demerger.

SOME SPECIFIC CGT ISSUES

Integrity measures

Integrity measures for demergers are contained in the Tax Act, aimed at ensuring that the dividend exemption is limited to 'genuine' demergers, rather than those demergers specifically designed to generate the dividend exemption. These demerger dividend provisions are complex and cannot be fully explored in the current forum, but these provisions are onerous. Importantly, a demerger undertaken as part of an arrangement to sell the demerged company, and therefore potentially access discount capital gains, could fall foul of the integrity measures.

Practical application of demergers to business succession

In many situations, CGT has restricted the ability to split a business into different parts to be ultimately owned by different interests. With a careful eye on the integrity measures, the demerger rules could allow for a privately-held business to be broken into various parts, with the demerged interests retained, and the existing interests disposed of but tax advice should e obtained in this case

LOANS, DIVISION 7A AND DEBT FORGIVENESS

Some of the taxation matters often overlooked when dealing with family assets and private companies are:

- The treatment of loans under Division 7A which treats non-commercial loans to shareholders or associates as deemed dividends. Commonly, private companies are used as an income trap, and after-tax profits may be lent to shareholders or associates. If the loans are not on terms prescribed in the legislation, or annual loan repayments are not met, the loans could be treated as deemed unfranked dividends to the shareholder. The company may also incur a debit to its franking account
- During the course of a restructure, to enable business succession plans to be effected, extreme care must be taken to ensure that:

– New debts are not created that fail to satisfy the Division 7A requirements.
– Pre-4 December 1997 debts are not refreshed up and hence brought within Division 7A.
– Old debts are not forgiven and thereby treated as deemed dividends.
– The interaction of Division 7A and trusts is not overlooked.

There are no specific Division 7A concessions dealing with loans made, or released, on the death of the borrower, however the debt release could be a deemed (unfranked) dividend.

LOANS, DIVISION 7A AND DEBT FORGIVENESS

Additionally, the commercial debt forgiveness rules must be considered in any restructure. Transactions involving debts can inadvertently wipe out tax losses, capital losses or other tax balances of the borrower. These rules could apply, where, as part of a succession strategy:

- a shareholder agrees to forgive debts due to him/her by the company.
- debts may be assigned.
- equity is injected into a company which is then used to repay debts.

STAMP DUTY

Stamp duty issues tend to go hand-in-glove with estate planning. Some critical observations are outlined below.
Some basic stamp duty issues arise:

- When there is a transfer of assets between one entity/person and another entity/person
- When there is a declaration of trust or transfer of property to a trust
- On resettlement
- When there is a transfer of assets on the death of a person, and
- When buy/sell agreements are entered into.

Transfer of assets

A transfer of assets from one person/entity to another person/entity as a normal sale or gift will generally attract stamp duty. The particular rate of duty and type of duty will depend on the asset involved (and possibly any underlying assets) and the jurisdiction that covers the transaction (stamp duties being a state impost rather than a Federal impost).

STAMP DUTY

Transfer to a trust

In various states in Australia there are a number of potential traps in transferring property to trusts. The transfer could be regarded as either a conveyance and/or a declaration of trust.
In either or both circumstances, ad valorem duty would be levied on the market value of the asset transferred. Where possible, the trust deed should be established with a nominal settlement sum and stamped. Any settlements of property on the trust should occur subsequently and should be in the form of cash rather than in specie.

Resettlement

In situations where a trust is being reconstructed or amended, it is advisable to avoid a resettlement of the trust. A 'resettlement' could occur, for example, where a new class of beneficiaries is added to the trust by way of a deed or another stampable instrument which will result in ad valorem duty being levied on that instrument.

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