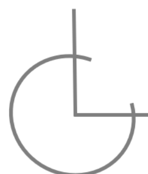
Passing on the Baton: Business Succession and the Estate Plan

Darius Hii, Director, CTA
Chat Legal Pty Ltd



Chat Legal Pty Ltd
ABN 64 621 391 553
letschat@chatlegal.com.au
Level 6, 200 Adelaide Street
BRISBANE QLD 4000
https://chatlegal.com.au

1 Overview

1.1 As of 30 June 2019, it was recorded that there were 2,375,753 active trading businesses.[1]

1.2 With an Australian population on that date of approximately 25,400,000,[2] there existed a business for every eleven individuals.

1.3 With such a high proportion of businesses in our society, there is no doubt that business succession planning is of critical importance for estate planning practitioners.

1.4 This paper considers a variety of issues relevant in implementing a robust and holistic business succession plan, such as:

(a) bringing on new business owners;

(b) dealing with retained earnings prior to exit;

(c) structuring an insurance funded buy sell deed;

(d) utilising the small business capital gains tax (**CGT**) concessions as part of a business succession plan; and

(e) family business succession planning factors.

1.5 Unfortunately, there is no 'one-size-fits-all' approach for business succession planning. How each of the above issues are applied to a client will depend on various factors including (but not limited to):

(a) whether there are multiple parties to the business;

(b) whether the business is a family business;

(c) whether the intended persons succeeding the business is a family member, employee or unrelated party;

(d) whether the business succession is to occur during the lifetime of a business owner or after death; and

(e) whether any steps are required to restructure the business.

1.6 The accompanying presentation will consider the impact of the above factors in relation to the discussed issues in this paper.

2 Bringing on new business owners

Business entities and succession planning

2.1 How new owners are introduced into a business will ultimately depend on the type of trading entity which it operates from.

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[1] Australian Bureau of Statistics, 8165.0 - Counts of Australian Businesses, including Entries and Exits, June 2015 to June 2019 – Released 20 February 2020 - https://www.abs.gov.au/ausstats/abs@.nsf/mf/8165.0#:~:text=History%20of%20changes-,Key%20statistics,2018%2D19%20there%20was%20a%3A&text=2.7%25%2C%20or%2062%2C462%2C%20increase%20in%20the%20number%20of%20businesses.

[2] Australian Bureau of Statistics, 3101.0 - Australian Demographic Statistics, Jun 2019 – Released 19 December 2019 - https://www.abs.gov.au/ausstats/abs@.nsf/lookup/3101.0Media%20Release1Jun%202019#:~:text=Australia%27s%20population%20grew%20by%201.5%20per%20cent%20during%20the%20year,annual%20increase%20of%20381%2C600%20people.%22

2.2 It was noted in recent statistics and reports that non-corporate entities are significantly used as trading entities in Australia.[3]

2.3 As businesses conducted by sole proprietors do not offer scope to introduce new owners, save for forming a partnership; restructures are commonly seen to transfer the business into a more suitable entity for transitioning. Later sections of this paper will consider the available mechanisms in ensuring there are no adverse CGT consequences in undertaking such a restructure.

2.4 Of relevance, however, is the need to understand the trading structure of the business; and if unsuitable, ensure steps are taken to restructure the business accordingly.

2.5 Two of the more common non-sole proprietor trading structures are as follows:

(a) company (whether with individual or trust shareholders); and

(b) discretionary trust (whether with individual trustees, company trustee and/or an appointor role).

2.6 It is also useful to acknowledge the distinction in the above structures between ownership (who the underlying owners are), and control (those who will manage the business).

Company considerations

2.7 The use of a company as a trading entity is generally seen as preferrable.

2.8 The benefits of having a flat reduced tax rate and the ability to retain earnings within the business environment are often stated as reasons for establishing a company to operate a business.

2.9 Often these benefits will outweigh the disadvantages of losing the 50% general CGT discount and complexity of navigating Division 7A issues in the tax legislation.

2.10 The two key roles involved with a company are the:

(a) members (or shareholders who are the legal entities that own the shares and ownership interest in the company equal to the proportion of shares they own); and

(b) directors (being the persons who are responsible for making the legal decisions for the company).

2.11 From a succession planning perspective, the:

(a) management of the company can be dealt by putting in place appropriate processes and documents governing the succession of the director – for instance, pursuant to a shareholders agreement or a tailored company constitution; and

(b) ownership of the company is managed through ensuring the shares in the company pass to the right people – for instance through the use of call option agreement or

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[3] The 2017 RMIT Report regarding '*Current issues with trusts and the tax system*' at page 20 provided statistics of over 300,000 discretionary trusts being used for trading or services/management activities; Australian Bureau of Statistics, 8165.0 - Counts of Australian Businesses, including Entries and Exits, June 2015 to June 2019 – Released 20 February 2020 - https://www.abs.gov.au/ausstats/abs@.nsf/mf/8165.0#:~:text=History%20of%20changes-,Key%20statistics,2018%2D19%20there%20was%20a%3A&text=2.7%25%2C%20or%2062%2C462%2C%20increase%20in%20the%20number%20of%20businesses , provided statistics that only 37.9% of businesses were trading through a corporate structure with over 55% being traded by sole traders and approximately 248,132 businesses traded through a partnership structure

transfers before or after the death of existing key persons (who could be the ultimate owners of shares).

2.12 Where the shares are held by individuals, that individual will require an appropriate Will to specifically ensure the shares are gifted to the relevant recipient. Where the intended recipient is a family member chosen to succeed the business, the Will could be prepared to specifically gift the shares directly to the recipient or indirectly to the recipient by a testamentary trust.

2.13 Complications can arise with shares held by individuals in a family business where it is likely that an individual's Will could be challenged. Potential arguments in having an individual's Will challenge can arise:

(a) where a disgruntled family member believes they have not their fair share under a Will (which is common in blended family situations between children from a prior relationship and a current spouse);

(b) where certain promises were made to family members that the family business would pass to them, and such promises were not followed through in the documentation; or

(c) where it can be argued that a deceased failed to have adequate mental capacity in making their Will.

2.14 In situations where there is a chance of a Will challenge, steps should be taken to mitigate the likelihood of disruption with the business transition. Some available solutions can include restructuring the shareholding during the lifetime of the individual such that the shares do not pass pursuant an individual's Will (i.e. by transferring the shares into a trust), or implementing arrangements such as a 'gift and loan back arrangements' to deter persons from challenging an estate.

2.15 Where the shares are held by trustees for a trust, then the terms of the trust will need to be reviewed and documents prepared to ensure control of that trust passes to the relevant recipient/s.

2.16 In contrast, if the shares are to be sold to a non-family member for value, then steps could be taken to put in place appropriate option agreements to enable an intended successor to purchase the shares from the deceased's estate or shareholding trust at a prior agreed value or valuation mechanism.

2.17 If the shares are held by other companies, then the succession planning considerations above will need to be made in relation to that holding company.

2.18 Where there are multiple owners of a company, then steps should be taken to ensure an appropriate shareholders agreement or company constitution is drafted containing:

(a) directorship appointment and share right provisions – which if drafted appropriately, can enable an incoming owner to integrate seamlessly into the business

(b) pre-emption right provisions – which would enable continuing owners to have a first right to acquire an existing owner's interest in the business (to ensure existing owners are not forced into business with an unwanted third party who bought an existing owner's interest);

(c) exit mechanisms due to involuntary events (such as retirement, death, total permanent disablement or breach of agreement).

2.19 Additional issues that should be addressed as part of a comprehensive shareholders agreement may include:

(a) what type of business is to be carried on?

(b) will all of the parties be actively involved in the day-to-day operations of the business?

(c) how will day-to-day decisions of the company be made (for instance, by simple majority decision of the directors?)

(d) how will decisions in relation to dividends being paid by the company be made?

(e) how will decisions in relation to changes to the company's capital structure (such as the issue of new shares or changes to share rights) be decided? Is a unanimous resolution of the directors and/or shareholders appropriate?

(f) how will the company be funded? If shareholder loans are to be provided, what terms will apply to those loans?

(g) should a restraint of trade apply to the shareholders/directors and if so, for what duration and geographic area?

(h) will the parties be required to keep company information, such as financial records and business plans, confidential?

(i) how should any disputes between the shareholders or directors be resolved? Is referral to mediation and then arbitration appropriate?

2.20 In addition to succession planning considerations, the tax and asset protection objectives of the incoming owner may also of importance. Specifically:

(a) having a discretionary family trust hold shares in a trading company offers flexibility in distributing franked dividends within a family group; and/or

(b) having a discretionary family trust hold shares in a trading company reduces the accessibility for the trustee in bankruptcy to cease title of the shares in the event a key individual is sued in their personal name.

Discretionary trust

2.21 Although not typically associated as the 'go-to' structure for operating businesses (largely due to the fact that all profits made in a year must be distributed out of the trust to beneficiaries as accumulation of such profits results in the top marginal tax rate applying), discretionary trusts are commonly found in family businesses.

2.22 Often dubbed 'family trusts', the flexible nature in being able to distribute profits between a group of family member beneficiaries and changing such distribution pattern each year can be seen as advantages in themselves for those family businesses. This is possible due to the nature of what a trust is, and the mechanisms of a discretionary trust.

2.23 Broadly, a trust is a legal relationship where there is:

a a legal owner of property (the '**Trustee**'), who;

b holds the property ('trust property');

c for the benefit of others (the '**Beneficiaries**'); and

pursuant to certain terms or rules ('trust deed').

2.24 Unlike companies and sole traders, a trust is not a separate legal entity. Instead, the Trustee looks after the property and manages the trust (i.e. the management position). Any benefits generated from the trustee's management can then be given to the Beneficiaries (i.e. the owners).

2.25 The complexity that a discretionary trust adds to ownership is the fact that there is a broad ***discretion*** of the Trustee to decide who can benefit from the trust.

2.26 Whilst other trusts may fix who can benefit (and thereby there can be a clear ownership percentage), a discretionary trust blurs this ownership percentage by allowing the Trustee to decide (at the Trustee's discretion) who can benefit from the trust, whilst being able to change this discretion on a yearly basis.

2.27 The 'owners' (i.e. the Beneficiaries) of a discretionary trust are therefore more reliant on the decision-making of the Trustee and absent any other role, are often named or involved at the Trustee level.

2.28 That other role referred relates to a role who can have the ability to change the Trustee. This role is often called the 'appointor' or 'principal' role (**Appointor**), and can even go by other terms.

2.29 A benefit of such a role is that the underlying owners of a discretionary trust can exert a form of influence over the Trustee to make decisions in the best interest of the owners, else they be replaced with someone more complying.

2.30 It is noted, however, that not all discretionary trusts hold an Appointor role.

2.31 Although it is common for family businesses to align all the roles (Trustee, main Beneficiaries and Appointor role) together, the flexibility of having these separate roles become more apparent when undertaking a succession plan for the trust.

2.32 Practically, from a succession planning perspective for a discretionary trust, it is crucial to understand who takes over the Trustee and/or Appointor role.

2.33 Generally, the trust deed will outline a default position on who takes control on the passing of individuals in those roles as well as provide general powers allowing for successors to be nominated. However, each trust deed must be reviewed to confirm this position as each trust deed providers draft their documents differently.

2.34 Issues that must be considered in the trust deed relating to the succession of the trust include, whether the trust deed:

(a) states who takes control of the relevant role in default of any specified nomination;

(b) provides a power to the Trustee or Appointor in nominating a successor (and if the power can be made by Will);

(c) imposes restrictions on who can be a successor (including if there are limits on the number of nominations);

(d) can be amended to include broad powers if the terms are considered too limited.

2.35 Where companies are involved in these roles, then relevant company documents (such as constitutions) must be considered in addition to the terms of the trust deed.

2.36 More curious questions include:

(a) whether an individual or company should be appointed into the Trustee and/or Appointor role as part of the transition strategy today rather than in the future; and

(b) whether steps can be taken to maximise the trust's vesting date, or potentially extending it indefinitely under South Australian trust law.

2.37 Due to the nature of a discretionary trust, it is not common to see multiple owners operate a business from a single discretionary trust. Rare exceptions, however, can include:

(a) parents passing control of the family business to multiple children, who continue to work in tandem in the short term; and

(b) separate family groups who have tailored made classes in the discretionary trust 'splitting' the income and capital of the trust between multiple beneficiary classes.

2.38 Despite these exceptions, discretionary trusts are not generally recommended as trading vehicles where there are multiple potential independent owners. Restructuring the business into a corporate entity, unit trust or partnership of discretionary trusts would be preferred; so that each owner will be entitled to a fixed interest in the business.

Other trading structures

2.39 Unit trusts and partnerships (whether a partnership of individuals, companies or discretionary trusts) may also be used as a trading entity.

2.40 These structures are commonly used when there are multiple owners, due to the ability for business owners to have a fixed interest in the above entities.

2.41 The succession planning considerations of a company will therefore also be applicable for such trading structures in the context that:

(a) the issue in relation to the shareholding of a company would apply for units in a unit trust or partnership interest in the partnership;

(b) the issue in relation to the directorship of a company would apply at the Trustee level for a unit trust.

2.42 Unitholders and partnership agreements would also be recommended to ensure clarity is sought as to the rights of a business owner.

Additional company issues

2.43 In addition to the succession planning issues identified above in relation to companies, the following commercial considerations should also be factored when selling a business.

2.44 Where the shares in a company are held by a sole owner, then it is prudent for the parties to consider whether the business itself or the shares in the company should be sold.

2.45 Key factors that can impact the parties' decisions include:

(a) the CGT consequences of selling the business or shares directly – for example, companies are not entitled to access the general 50% CGT discount; whilst shareholders who are individuals or trusts may be eligible to access such concessions;[4]

(b) historical trading liability considerations – a buyer will generally prefer to buy the business assets rather than acquiring an existing entity. This is to ensure that the buyer does not have liability for any historic claims that may lie in waiting against the business entity for past conduct, either known or unknown by the seller;

[4] Division 115-A *Income Tax Assessment Act 1997* (Cth)

(c) stamp duty consequences – in some jurisdictions (such as Victoria), there is no material difference in the duty cost between buying business assets compared to equity in a business structure, whereas in other jurisdictions (such as Queensland), the transfer of business assets will still create a duty liability for the buyer based on the unencumbered market value of the assets being acquired; and

(d) whether a partial or full sell-down is occurring – it will typically be more appropriate for the buyer to acquire equity in the existing vehicle so tax and stamp duty costs are only imposed in respect of the proportionate interest being acquired, rather than on 100% of the assets being transferred to a new vehicle. That said, in some instances tax and stamp duty concessions may be available to allow the seller to transfer the business assets to a clean skin vehicle, prior to selling equity in that new vehicle to the buyer.

Commerciality of succession plan

2.46 Regardless of the structure of the trading entity, the commerciality of the transition should also be considered.

2.47 Will the transition occur for no consideration or under-market value? This can be common:

(a) when dealing with family businesses and parents exiting the business by gifting it to their children to operate;

(b) as part of post-death transitions for family businesses where children can receive their inheritance through the business; and

(c) occasionally, between unrelated parties and from the business owner to a key or ear-marked employee.

2.48 Alternatively, will the transition occur on arm's length terms (regardless of it being between family members or unrelated parties)? Relevant issues to consider for such transactions include:

(a) the purchase price and the timing for it to be paid (i.e. whether there will be any retention amounts or earnouts);

(b) whether any assets are being excluded from the sale, including the proposed treatment of working capital, work-in-progress, debtors and retained profits;

(c) whether the buyer will take on the existing liabilities, including assuming responsibility for employee annual leave, sick leave and long service leave entitlements;

(d) what level of due diligence will be undertaken by the buyer;

(e) whether the seller will be subject to any restraint of trade and if so, the scope of the restraint; and

(f) what types of warranties and indemnities will be provided by the seller and whether any of those warranties and indemnities will be backed by personal guarantees (if the seller is a trust or company).

2.49 Financing of a business transition for value should also be considered, and in circumstances where the transition is vendor-financed, the impact of having a loan owing to an existing business owner should be considered as part of the business owners' personal estate plan. This is of particular importance where a business owner sells the business to a particular child as part of that child's inheritance; whilst other family members benefit through an estate plan.

The importance of the right structure

2.50 To highlight the importance of having an appropriate business structure as part of a succession plan, consider the following example:

(a) John operates a real estate agency business through a family trust with a company trustee.

(b) The trust was established in the early 1980s and included the usual beneficiary class being John, his spouse, their lineal descendants and parents.

(c) Now in his 70s, John wishes to pass the equally business to his daughter, Jane, and a key employee, David.

(d) Due to the nature of the family trust, even if John passed control of the company trustee and any 'appointor' role to Jane and David jointly, issues would be present including (but not limited to):

(i) David (and his family) are not beneficiaries of the trust;

(ii) If a shareholders agreement is not prepared for the company trustee, then there is no dispute resolution mechanism given that Jane and David would likely need to unanimously agree on decisions;

(iii) Where decisions are not made as to the income or capital of the trust, such income and capital are likely to be distributed to John and his family (such as Jane).

(e) In such circumstances, utilising a discretionary trust would not be suitable and steps would need to be taken to transfer the business into a more appropriate entity.

(f) Although restructuring considerations will be considered below, potential solutions could include:

(i) having David establish his own family trust, and acquiring a 50% interest in the business to be held as a partnership of trusts;

(ii) transferring the business to a company with the shares held equally between David and Jane (or through a discretionary trust);

(iii) transferring the business to a company wholly owned by John's family trust and then selling 50% of the shares to David for market value.

(g) The most suitable option will ultimately depend on:

(i) various tax and stamp duty costs in implementing the restructure;

(ii) whether the transfer will occurring before or after the death of John; and

(iii) the commercial terms of the succession plan.

2.51 Unfortunately, the vast majority of businesses are not established with succession planning in mind (often due to owners' primary goal being the initial success for the business), and the need to undertake a pre-succession plan restructure is not uncommon.

3 Dealing with retained earnings prior to exit

3.1 Business owners often turn to 'passing on the baton' as they reach retirement age.

3.2 By that point in time, their business would have accumulated significant retained earnings.

3.3 Due to the nature of companies (being trading entities that allow for the retention of profits at a corporate tax rate), businesses trading through such structures will often hold large retained amounts.

3.4 This is in contrast to businesses that trade through discretionary trusts who are required to distribute profits each financial year to avoid paying the top marginal tax rate on accumulated profits.[5]

3.5 A key question, therefore, relates to how business owners are able to deal with retained earnings. In particular:

(a) What options are available to extract retained earnings from a company?

(b) How to deal with franking credits for a departing shareholder?

3.6 Prior to extracting retained earnings, a company must ensure it's assets exceed its liabilities immediately before a dividend is declared. Further, the payment of the dividend must be fair and reasonable to the company's shareholders as a whole and not materially prejudice the company's ability to pay its creditors.[6]

Extracting retained earnings prior to exit

3.7 Various issues can arise for business owners in relation to extracting multiple years' worth of retained earnings. These issues include where an exiting shareholder:

(a) holds their share in the company in their personal name – as the shareholder will lose the flexibility of distributing such retained earnings to other family members and flattening the tax rate of historical profits between multiple individuals or a company;

(b) holds their share in the company with a discretionary trust – as the shareholder will be forced to either:

(i) distribute all retained earnings to family members; or

(ii) distribute retained earnings to a 'bucket company' and potentially paying top-up tax due to the difference in company tax rate between a 'base rate entity' and ordinary company.

3.8 The above issues arise as it is standard tax planning for retained earnings to be stored in a company environment and dividends slowly distributed to assist business owners to self-fund their retirement. Therefore, for a business owner to be forced to receive the entirety of the retained earnings in a single income year (due to being the individual shareholder and the need to exit the business structure), they will lose the ability to 'pick and choose' the timing of extracting retained earnings.

3.9 This particular issue can be managed either through:

(a) the interposition of a new holding company between the exiting individual and trading company (which the individual is exiting); or

(b) the issuing of 'dividend access shares' in favour of a company or discretionary trust controlled by the exiting individual.

New holding company

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[5] Section 99A *Income Tax Assessment Act 1936* (Cth)

[6] Section 254T *Corporations Act 2001* (Cth)

3.10 The interposition of a holding company between the exiting individual and trading company allows for dividends to be declared and distributed to the holding company for retention.

3.11 In addition to allowing the exiting business owner to retain earnings in a corporate environment after exiting the trading company, the interposition of the holding company reduces the need to pay any 'top-up' tax on dividends which may have franking credits based on the lower company tax rate.

3.12 Section 23 *Income Tax Rates Act 1986* (Cth) sets out the rate of tax payable by companies. As of the date of this paper, the rates of tax for a company are as follows:

(a) if the company is a 'base rate entity' for an income year – 26%; or

(b) otherwise – 30%.

3.13 A base rate entity is defined to be an entity:[7]

(a) in which no more than 80% of its assessable income for the income year is 'base rate entity passive income'; and

(b) its aggregated turnover[8] for the income year is less than $50 million.

3.14 Base rate entity passive income is defined to be income that is any of the following:[9]

(a) a distribution by a corporate tax entity **other** than a non-portfolio dividend[10] (within the meaning of section 317 *Income Tax Assessment Act 1936* (Cth));

(b) an amount of a franking credit on such a distribution;

(c) a non-share dividend by a company;

(d) interest, royalties and rent;

(e) net capital gain;

(f) an amount included in the assessable income of a partner in a partnership or of a beneficiary of a trust estate to the extent that the amount referable (either directly or indirectly through one or more interposed partnerships or trust estates) to another amount that is base rate entity passive income.

3.15 Therefore, a company:

(a) where at least 20% of its income **does not** constitute 'passive income'; and

(b) together with its related entities, has a turnover of less than $50 million,

will be taxed at the 26% company tax rate.

3.16 For trading companies, a substantial amount of their income will be generated from trading activities. Further, to be considered a base rate entity (thereby receiving the lower company tax rate), at least 20% of the company's income need be from trading activities.

3.17 For holding companies that hold at least a 10% share in a trading company, the distribution of retained earnings to that holding company will not amount to base rate entity passive

[7] Section 23AA *Income Tax Rates Act 1986* (Cth)
[8] See section 328-115 *Income Tax Assessment Act 1997* (Cth) for the meaning of aggregated turnover
[9] Section 23AB *Income Tax Rates Act 1986* (Cth)
[10] Section 317 *Income Tax Assessment Act 1936* defines a non-portfolio dividend to mean '*a dividend…paid to a company where that company has a voting interest…amounting to at least 10% of the voting power…in the company paying the dividend.*'

income as the dividend relates to a non-portfolio dividend; provided such retained earnings equates to at least 20% of the holding company's income for that particular income year.

3.18 In contrast, a 'bucket company' receiving retained earnings through a trust distribution will be receiving such amount as 'base rate entity passive income'. Provided the bucket company does not receive trading income or non-portfolio dividends, the bucket company will not satisfy the definition of base rate entity, and will be required to pay the differential (if any) in company tax rate of 4% (as of the financial year ending 30 June 2021).

Dividend access shares

3.19 Dividend access shares (also known as 'dividend only shares') are a special class of shares which can be introduced into a company's constitution and allotted to a new shareholder, which carry the right to receive a dividend as determined by the company's directors in their absolute discretion from time to time.

3.20 Dividend access shares are typically structured such that:

(a) the holder does not have any right to attend or cast votes at shareholder meetings and does not have any rights to the repayment of capital from the company;

(b) the holder is only entitled to dividends at the sole discretion of the directors of the company from time to time and is not entitled to the dividends until they are actually paid; and

(c) the shares can be redeemed for a nominal amount (or at a pre-defined redemption price in the constitution) at the discretion of the company. In some instances, the shares may be automatically redeemed after a specified period of time, typically less than four years.

3.21 Historically, the argument adopted by many taxpayers and their advisers has been that in light of the limited rights outlined above, the market value of the shares at the time of their issue (and at the time of any subsequent redemption) is nominal and as a result, no adverse tax consequences arise from their allotment.

3.22 That said, the Tax Office has expressed significant concern regarding the use of dividend access shares. Those concerns are articulated in Taxpayer Alert TA 2012/4 (**Taxpayer Alert**) and the specific issue of dividend stripping is further explored in Taxation Determination TD 2014/1.

3.23 TA 2012/4 states:

'The ATO considers that arrangements of this type give rise to the following issues relevant to taxation law, being whether:

(a) an amount should be included in the assessment of any entity as an ordinary dividend or as a deemed dividend under Division 7A of the Income Tax Assessment Act 1936 (ITAA 1936);

(b) an amount should be deductible for the target company or its shareholders in respect of any fees paid to an entity recommending the arrangement under section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997) or another provision;

(c) the new shares may be debt interests under Division 974 of the ITAA 1997;

(d) a taxing event may generate a capital gain under CGT event K8 for the original shareholders of the target company by virtue of the direct value shifting rules in Division 725 of the ITAA 1997;

(e) an amount should be allowable as a franking credit/offset under Part 3-6 of the ITAA 1997;

(f) the arrangement may be a scheme by way of or in the nature of, or have substantially the effect of, dividend stripping under section 177E of the ITAA 1936;

(g) the arrangement may be a scheme to which sections 177A to 177D of Part IVA of the ITAA 1936 (the general anti-avoidance rules) may apply;

(h) the general anti-avoidance rule for franking credit benefits on section 177EA of the ITAA 1936 may apply to the arrangement;

(i) any amounts received by an entity recommending the arrangement are assessable income of that entity;

(j) any entity involved in the arrangement may be a promoter of a tax avoidance scheme for the purposes of Division 290 of Schedule 1 of the Taxation Administration Act 1953 (TAA 1953); and

(k) any entity involved with the arrangement that is a tax practitioner may be referred to the Tax Practitioner Board under the Tax Agent Services Act 2009 regarding matters relevant to the Code of Professional Conduct.'

3.24 The Tax Office's invocation of the promoter penalty rules in the Taxpayer Alert has understandably created significant concern amongst advisers and resulted in a material reduction in the use of these arrangements, since 2012.

3.25 That said, the widely held view amongst the tax community is that subject to the over-arching operation of the Part IVA anti-avoidance rules to the arrangement, each of the other areas of concern mentioned by the Tax Office can be satisfactorily addressed in an appropriately structured arrangement, such that no adverse tax consequences should arise.

3.26 Where a client is advised of the risks and wishes to proceed, the dividend access arrangement would typically be implemented as follows:

(a) the company's constitution would be updated to create the new class of dividend access share (if that share class does not already exist);

(b) a dividend access share would be allotted to a family trust for nominal consideration of $1. The family trust will likely need to make a family trust election;

(c) a dividend equal to the retained profits would be declared as a dividend to the family trust and subsequently distributed to either individual family members or a corporate beneficiary;

(d) at some point either before or after the sale transaction, the dividend access share would be redeemed by the company. Key considerations in this regard include:

(i) ensuring the holding period rules for franking credits are satisfied in respect of the dividend;

(ii) considering the impact on the small business CGT concessions (and in particular, the ability to satisfy the CGT concession stakeholder test) if the share remains on issue; and

(iii) addressing the wider commercial implications for the transaction, such as the buyer's willingness to acquire a vehicle which has a dividend access share on issue.

3.27 Naturally, the tax avoidance risk is materially higher if a dividend access share arrangement is implemented within a short period of time before a share sale occurs.

Franking credits for a departing shareholder

3.28 Where a shareholder of a company is a discretionary trust, care must be taken to ensure franking credits are able to be claimed.

3.29 Specifically, Division 1A of Part IIIAA of *Income Tax Assessment Act 1936* (Cth) (repealed effective from 1 July 2002) applies to the ability for franked dividends to flow through a trust to its beneficiaries.

3.30 Despite the repeal of such legislation, Taxation Determination TD 2007/11 confirmed the Tax Office's acceptance of the old law:

The very wording of sections 207-145 and 207-150 makes it clear that regard is to be had to the rules in Division 1A in determining whether a person is a qualified person for the purposes of these provisions in respect of a franked distribution, irrespective of whether the distribution is made after 30 June 2002. There is nothing in the relevant extrinsic material to indicate the contrary.[11]

3.31 Broadly, the Tax Office has accepted that to be entitled to a franking credit tax offset, a taxpayer is required to be a 'qualified person' in relation to a franked dividend. The qualified person test ensures only the true economic owners of shares benefit from franking credits attached to distributions made from the shares.

3.32 A shareholder generally meets the qualified person test if they satisfy either the:

(a) holding period rule

(b) where applicable, the related payments rule.

3.33 The related payments rule only applies to a distribution on shares where there is an obligation to pass on the benefit or value of the distribution to another. Given that the extraction of retained earnings are intended to remain with the exiting business owner, the related payments rule will generally not be applicable.

3.34 Therefore, in order for a shareholding trust to satisfy the qualified person test, they will need to comply with the holding period rule.

3.35 The holding period rule requires shares to be held 'at risk' for a continuous period of at least 45 days (90 days for preference shares).

3.36 Where a discretionary trust holds shares, then steps must be taken to calculate the number of days in which a beneficiary held the interest in the shares to satisfy the holding period rule.

3.37 Former section 160APHL of *Income Tax Assessment Act 1936* (Cth) outlines the mechanism in how to calculate a beneficiary interest in the underlying shares based on the fixed interest that such beneficiary holds in a trust. Such provisions do not apply if the relevant trust is a family trust within the meaning of Schedule 2F *Income Tax Assessment Act* 1936.[12]

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[11] TD 2007/11 at paragraph 9

[12] Section 160APHL(10) If:

(a) the trust is not a family trust within the meaning of Schedule 2F…

the taxpayer has, in addition to any other long and short positions (including the positions that the taxpayer is taken to have under subsection (8)) in relation to the taxpayer's interest in the relevant share or relevant shares,

3.38 Further, section 160APHL(11) *Income Tax Assessment Act 1936* states that only a 'vested and indefeasible interest' will constitute a fixed interest, therefore being impossible for beneficiaries of discretionary trusts to satisfy such holding rule requirements.

3.39 Given the difficulty in calculating the number of days a beneficiary held an interest in the shares, steps will need to be taken to make family trust elections to ensure the discretionary trust is considered a family trust for Schedule 2F purposes.

4 Structuring an insurance funded buy sell deed

Self-funded insurance buy sell deed

4.1 For any business with multiple owners, the death or incapacity of one of the owners (referred to in this paper as a '**triggering event**') can create significant heartache and trauma.

4.2 In extreme cases, the financial stress created by a triggering event can render the business unable to continue operating and force its closure.

4.3 The common issues which can arise from a triggering event include:

(a) the affected owner's family suffering financial uncertainty, if the remaining business owners are unable or unwilling to buy the affected owner's equity from them for market value;

(b) the remaining business owners having no ability to purchase the equity held by the affected owner, either because:

(i) they do not have funding for the purchase price; or

(ii) the affected owner is unwilling to sell;

(c) the remaining owners may become involuntary business partners with the affected owner's spouse or children, where a sale cannot be negotiated; and

(d) the affected owner's family and the remaining business owners may disagree on the market value of the equity and therefore be unable to agree on the terms of a sale.

4.4 One strategy for managing these risks is to implement an insurance funded business succession agreement.

4.5 These arrangements are usually structured as follows:

(a) each key individual would take out life, total and permanent disablement and potentially trauma insurance from an insurer;

(b) the policy amount would be at least equal to the market value of that owner's equity in the business; and

(c) that owner pays their own insurance premiums and is nominated as the beneficiary of the insurance policy.

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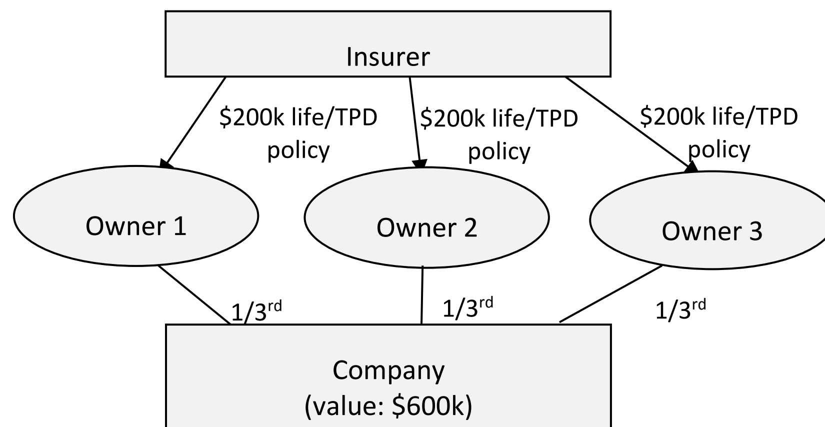
a short position equal to the taxpayer's long position under subsection (7) and a long position equal to so much of the taxpayer's interest in the trust holding as is a fixed interest.

4.6 Diagrammatically, the structure is as follows:



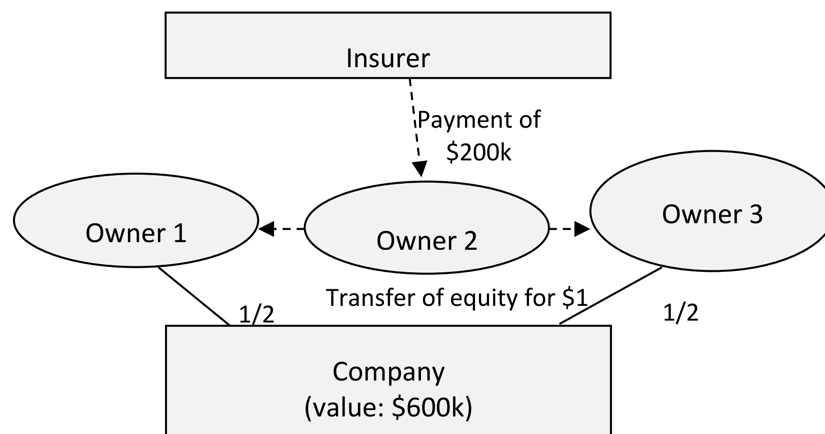
4.7 In conjunction with the insurance policies being taken out, the parties would enter into a business succession agreement.

4.8 The agreement provides that:

(a) if a triggering event occurs to an owner, the remaining owners have an option to purchase the affected owner's equity in the business; and

(b) the purchase price for the transfer of equity is calculated at the market value of the affected owner's equity, less the insurance proceeds they receive. In most instances, this means the purchase price would be $1.

4.9 Diagrammatically, the outcome of this arrangement (if the triggering event occurs to Owner 2) is as follows:



4.10 The outcome of the arrangement is:

(a) the owner affected by the triggering event (Owner 2) is removed as an owner of the business and the remaining owners (Owners 1 and 3) are able to continue operating the business, without interference from the affected owner's family;

(b) the affected owner's family is compensated for the value of the equity, by way of the insurance proceeds; and

(c) the remaining owners are not required to fund a buyout of the affected owner.

4.11 All parties have certainty in relation to the outcome if an owner is affected by a triggering event at any point in the future.

4.12 There are a number of potential taxing points that need to be considered in relation to any insurance funded buy sell arrangement.

4.13 These include the tax (and potential stamp duty) consequences of signing the buy sell agreement, granting the put and call option upon a triggering event occurring, the exercise of the option by either party and the receipt of the insurance proceeds by the affected owner.

4.14 In relation to the buy sell agreement itself, it is prudent to ensure the agreement is drafted in such a manner that the grant of the put and call options are conditional upon the occurrence of a triggering event (such as the death or incapacity of a party), rather than the put and call options being granted upon signing of the document but only being exercisable upon a triggering event occurring.

4.15 While the distinction between these two approaches may seem arbitrary, significant CGT consequences can flow.

4.16 Specifically, under the first approach, the relevant CGT event (CGT event D1 – grant of option) only occurs if and when a triggering event occurs, as that is the point in time when the option is granted.

4.17 Conversely under the second approach, CGT event D1 occurs upon the signing of the agreement even though no triggering event has occurred.

4.18 Similarly, while historically some buy sell deeds had occasionally been drafted as mandatory sale agreements (where the document was an agreement to sell specific assets, conditional upon certain triggering events occurring), this approach can cause material adverse tax outcomes by triggering CGT event A1 at the time of signing.

4.19 The diagrams above illustrate a 'self-ownership' approach, where each key individual takes out a policy over their own life.

4.20 The benefits of a self-ownership approach include:

(a) the owner can choose to take out additional insurance for personal cover or to reduce debt with a single policy, meaning they only need to go through a single insurance under-writing process and is not subjected to repeated medical enquiries and examinations;

(b) if the owner leaves the business in the future, they can choose to retain their policy for personal cover without needing to make any changes to the policy ownership. This is particularly useful if the owner has suffered health conditions since the policy was originally taken out, which may make it difficult or impossible for them to obtain a new policy; and

(c) the insurance proceeds should be tax-free in the hands of the recipient and if the owner's estate plan incorporates a testamentary trust, the proceeds can flow into that concessionally taxed investment vehicle upon their death.

4.21 From a tax perspective, the CGT treatment of life, TPD and trauma insurance proceeds is dealt with in section 118 *Income Tax Assessment Act 1997* (Cth).

4.22 Section 118-300 *Income Tax Assessment Act 1997* (Cth) confirms that no CGT is payable on the receipt of life insurance proceeds following the death of the insured, provided that the proceeds are received by either:

(a) the original owner of the policy or instrument; or

(b) an entity that acquired the interest in the policy or instrument for no consideration.

4.23 Similarly, section 118-37 *Income Tax Assessment Act 1997* (Cth) confirms that no CGT is payable on the receipt of compensation (including insurance proceeds) a taxpayer receives, if the compensation is in relation to a wrong or injury suffered by the taxpayer or a relative of the taxpayer or a relative of the taxpayer.

4.24 'Relative' is defined in section 995 as follows:

'***Relative*** *of a person means:*

(a) The person's spouse;

(b) The parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of the person's spouse; or

(c) The spouse of a person referred to in paragraph (b).'

4.25 Together, sections 118-300 and 118-37 mean that under a self-ownership insurance model, the receipt of insurance proceeds should always be tax-free in the hands of the owner (or their estate), regardless of whether the triggering event is death, TPD or trauma.

Other ownership models

4.26 One alternative to the self-ownership insurance model is for the insurance policies to be owned by a special purpose trust.

4.27 The main benefit of this approach is that as the policies for all owners are centralised under one ownership model, the trustee can ensure the premiums for all owners are paid on time and can notify the parties if it becomes aware of any potential insurance issues or shortfalls.

4.28 By contrast, under the self-ownership model, each owner is responsible for paying their own premiums (albeit, funding may be provided by the business) and the other owners will not necessary be aware if one party has ceased paying their premiums or otherwise invalidated their policy.

4.29 Historically, the tax consequences of the trust ownership model were uncertain as the intended tax treatment relied on each owner being 'absolutely entitled' to their respective insurance proceeds, to ensure the proceeds would be tax free.

4.30 The concept of 'absolute entitlement' has been the subject of significant contention over the last 15 years, evidenced by the release of a draft ruling in 2004 (Taxation Ruling TR2004/D25) which remains unfinalised to this day.

4.31 In the context of decisions such as *CPT Custodian v Commissioner of State Revenue* [2005] HCA 53 and more recently *Oswal v FCT* [2013] FCA 745, there seems to be a compelling argument that under the current tax legislation, it is impossible for a beneficiary to ever be 'absolutely entitled' to an asset as against the trustee.

4.32 While this has been a cause for concern in the past, in 2015 the *Income Tax Assessment Act 1997* (Cth) was amended to:

(a) extend the exemption in section 118-37 relating to compensation for injury/illness, to expressly apply where the insurance proceeds are receiving by a trustee (provided the injured individual is a beneficiary of the trust); and

(b) provide a new CGT exemption in relation to the distribution of life, TPD and trauma proceeds from a trustee to the relevant individual.

4.33 Consequently, trust ownership models have become more popular since the 2015 amendments have added significant certainty to the tax outcome of such arrangements.

4.34 The other insurance approach which had been common historically was for some or all of the life, TPD and trauma policies to be held by a self-managed superannuation fund (**SMSF**).

4.35 This model was popular as it allowed the premiums to be paid from existing superannuation balances rather than requiring the owners to pay the premiums from their personal funds.

4.36 Superannuation ownership models were largely brought to an end between 2014 and 2015 as a result of several significant legislative and Tax Office changes.

4.37 Specifically:

(a) legislative amendments meant that from 1 July 2014, SMSFs were prohibited from acquiring 'own' occupation TPD policies or trauma policies, unless the ownership of the policies was being maintained under grandfathering rules. While SMSFs could still acquire 'any' occupation policies, significant injuries or illnesses were materially less likely to qualify for a payout under 'any' occupation policies than 'own' occupation policies; and

(b) in May 2015, the Tax Office released ATO Interpretative Decision ATO ID 2015/10 which asserted the view that if insurance policies were held by a SMSF to support a buy-sell arrangement, the ownership of the policy would breach section 62 (sole purpose test) and section 65(1)(b) (financial assistance prohibition) of the *Superannuation (Supervision) Act 1993* (Cth).

4.38 Not surprisingly, these two changes have resulted in the superannuation ownership model having been largely abandoned.

4.39 The final ownership model which the author has encountered on occasion is business vehicle ownership.

4.40 Under this approach, the business entity (such as the trading company) owns the insurance policies in respect of each owner.

4.41 This approach is fraught with risk and unintended consequences and often arises where clients have attempted a 'do-it-yourself' solution.

4.42 The problems that arise when insurance policies are owned by the trading vehicle include:

(a) the CGT exemption in section 118-37 in respect of TPD and trauma proceeds will rarely (if ever) be available, meaning the business entity will be liable for CGT for any triggering event other than death;

(b) as the insurance proceeds are received by the business vehicle, the market value of that vehicle will increase by a corresponding amount, resulting in adverse tax consequences for the party selling their equity interest;

(c) to the extent the insurance proceeds are intended to be extracted to the exiting owner, the distribution of those proceeds is likely to give rise to further tax costs (such as requiring a taxable dividend to be declared);

(d) the ownership model may in fact prevent the insurance proceeds from being paid solely to the exiting owner – for instance, if the proceeds are received by a company with only ordinary class shares on issue, the company's constitution would require all dividends to be paid to all shareholders proportionately to their shareholdings and would prohibit a dividend from being declared solely to one shareholder to the exclusion of the others; and

(e) any legal documentation which may have been prepared in respect of the arrangement (such as a buy sell deed) will rarely have identified and appropriately addressed all potential issues and in some instances, may leave the parties in a worse position than if the arrangement had never been entered into at all.

4.43 In summary, the business entity ownership model should never be utilised and in most instances, either the self-ownership model or trust ownership model will be more appropriate.

Valuation of equity

4.44 When insurance funded buy sell deeds are implemented, one issue which needs to be addressed is determining how the market value of an outgoing party's equity is to be determined.

4.45 In most instances, the intention is that the value of the insurance held by each owner exceeds the market value of their equity, such that the purchase price for the transfer of their equity is a nominal $1 payment.

4.46 However, there are a range of scenarios where the market value of the equity may exceed the value of the insurance which gets paid following a triggering event, including:

(a) if the cost of the insurance premiums are significant, the parties may choose to deliberately under-insure themselves on the assumption they can independently finance the balance of the purchase price if needed;

(b) the value of the business may increase significantly over time and the owners may not have increased the insurance cover by a corresponding amount – either by neglect or because the additional insurance is unable to be obtained;

(c) the parties may believe they have sufficient insurance only to discover upon a triggering event occurring that an exclusion in the policy prevents the proceeds from being paid, such as an existing health exclusion; or

(d) one of the parties may have invalidated their policy without the knowledge of the other parties (for instance, as a result of non-payment of premiums).

4.47 In each of these scenarios, the manner in which the purchase price is to be determined becomes critical.

4.48 The buy sell agreement should provide a detailed process for determining the purchase price and contain provisions setting out the manner and time period over which it is to be paid.

4.49 This may include generous vendor finance loan terms so the remaining owners can make repayments to the outgoing principal over a number of years, as funding becomes available.

4.50 The market value of the business can be contentious as:

(a) the outgoing owner will often over-value their equity in light of their previous contributions and profitability while the remaining owners will often under-value the equity. This is particularly an issue where the outgoing owner is deceased and the executor of the estate has limited knowledge of the business operations;

(b) the market value will likely decline in the short term if one of the key individuals becomes unable to work, as this can damage customer and supplier relationships and necessitate additional costs being incurred by the business, such as hiring replacement staff; and

(c) as the outgoing owner's family go through the emotional grief of a traumatic health event and the remaining owners suffer through the difficulty of keeping a business afloat after the loss of a key individual, parties can stop behaving rationally.

4.51 With those factors in mind, it is important for the market value to be determined by an independent expert. The expert should be experienced with valuing similar businesses and should have sufficient independence and credibility that both parties will accept their verdict as to the value of the equity being sold.

4.52 The agreement should also contain detailed valuation guidelines, addressing issues such as:

(a) whether any pre-agreed valuation methodologies or multiples should be utilised by the independent expert;

(b) the extent to which the impact of the exiting owner's departure on the profitability of the business should be taken into account;

(c) how to deal with surplus balance sheet assets, such as cash or retained profits; and

(d) the requirement for all parties to comply promptly with any requests for information from the independent expert.

4.53 Some clients will express a desire for simplicity by having a pre-agreed dollar value inserted into the agreement, reflecting their view of the market value of the business at the time the agreement is signed.

4.54 The obvious risk with this approach is that as the business increases in value over time, the agreement will become out-dated and may result in unjust outcomes if the agreed value is not regularly reviewed and updated.

4.55 Despite client assurances to the contrary, we should be skeptical of any client who is adamant that they will review and update the agreement on a regular basis – past experience tells us that the agreement will be placed in a drawer and not reviewed again until a triggering event occurs, despite the protests and promises by clients to the contrary!

4.56 One solution is to incorporate a fixed value for the business for a fixed period of time (say, 2 years). After the fixed period of time, the agreement would revert to an independent valuation unless the parties have taken steps to review and update the fixed value, in which case the new fixed amount would roll over for a further 2 year period.

4.57 This approach can satisfy the client demand of simplicity and certainty whilst also protecting them against the risk of that the business increases significantly in value over time, without the valuation in the agreement being updated in a timely manner.

Other types of insurance

4.58 Finally, it is worth noting that there are several other types of insurance a prudent business owner should consider.

4.59 A detailed insurance review by an accredited financial planner should include recommendations in relation to:

(a) taking out additional life/TPD/trauma insurance for the business owner's personal family needs, quite aside from any insurance taken out to replace their equity in the business;

(b) similarly, additional life/TPD/trauma insurance may be prudent for the business owner (or their family) to reduce external debt, such as a home loan;

(c) income protection insurance can ensure the owner has a replacement income stream in the event they become unable to work in the business and draw a salary or dividends for any reason; and

(d) key person insurance can provide an income stream for a business to replace lost revenue or provide funding for replacement staff to be hired, in the event one of the key individuals becomes unable to work.

(e) Each owner should consider the relevance of these additional policy types for their personal circumstances at the time the buy sell agreement is entered into, as it is usually more cost and time effective for these additional policies to be obtained at the same time as the buy sell deed policies, rather than going through a separate insurance under-writing process.

5 Small business CGT concessions and business succession

Restructuring the business to align with the succession planning intentions relating to ownership

5.1 Where it has been determined that the entity the business operates from requires restructuring (see paragraph 2.51), thought must be taken in relation to (at a minimum) the following factors:

(a) the tax implications, namely:

(i) income tax/CGT;

(ii) stamp duty; and

(iii) goods and services tax;

as well as other tax factors such as:

(iv) any effect on the cost base of assets; and

(v) managing existing loans and interest repayments;

(b) the commercial implications and impact of time spent contacting key clients, suppliers and financiers in relation to the impact the restructure may have on any existing contracts; and

(c) the cost of engaging professionals such as specialist tax advisors and lawyers.

5.2 While this paper will specifically consider the operation of the small business CGT concessions, this section will also provide an overview of *some* of the other available rollover, concessions and exemptions for CGT.

5.3 In deciding what strategy should be used, the preferred structure for the business to operate should be settled.

5.4 Potential CGT rollovers, concessions and exemptions available for use include (but are not limited to):

(a) transferring an asset from an individual or trustee of a trust to a company (with the shares held by the transferor)[13] – this can be useful when it is determined that a business is better suited to being operated from a company rather than a sole trader or a trust;

[13] Subdivision 122-A *Income Tax Assessment Act 1997* (Cth)

(b) transferring an asset held by partners in a partnership to a company (with the shares held by the partners accordingly)[14] – this could be relevant when the business is conducted by multiple family members in a partnership, and it is determined that it would be better suited to be operated from a company;

(c) transferring an asset held by a 'unit' trust to a company (with the shares in the company held by the unitholders of the 'unit' trust)[15] – again, this can be useful when it is determined that a business is better suited to being operated from a company rather than an unit trust;

(d) utilising the small business restructure rollover to move a business from one structure to another[16] – this option is available when there are no existing rollovers available to move the business into the desired structure (for example transferring the business from a company to a discretionary trust);

(e) utilising the small business CGT concessions to move business assets from one structure to another (discussed further below)[17] – this option is available regardless of the structure but is only limited to 'small businesses';

(f) splitting a business under the demerger rules;[18] and

(g) forming a tax consolidated group and transferring assets within the group.[19]

5.5 When employing a strategy, specialist tax advice must be sought to ensure all the appropriate requirements are met. Such advice will also 'marry' the various tax considerations that intertwine when undertaking a restructure, including GST factors.

Small business CGT concessions – effect of the concessions

5.6 In addition to allowing for business restructures to be undertaken without incurring significant CGT consequences, the small business CGT concessions are also used to reduce the amount of CGT payable by an exiting business owner.

5.7 This applies in both circumstances where an existing business owner sells the business:

(a) for consideration (creating a capital gain); or

(b) for no consideration or under market value when the parties were not dealing with each other on arm's length terms.[20]

5.8 If available for a business owner, the small business CGT concessions can reduce capital gains made by an entity as follows:

(a) if the entity held the sale asset for at least 15 years – the entire capital gains is disregarded – the **15-Year Exemption**;[21]

(b) otherwise:

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[14] Subdivision 122-B *Income Tax Assessment Act 1997* (Cth)
[15] Subdivision 124-N *Income Tax Assessment Act 1997* (Cth)
[16] Subdivision 328-G *Income Tax Assessment Act 1997* (Cth)
[17] Division 152 *Income Tax Assessment Act 1997* (Cth)
[18] Division 125 *Income Tax Assessment Act 1997* (Cth)
[19] Part 3-90 *Income Tax Assessment Act 1997* (Cth)
[20] Section 116-30 *Income Tax Assessment Act 1997* (Cth) substitutes the market value of the asset transferred and CGT still be payable where the market value of the asset exceeds the cost base
[21] Subdivision 152-B *Income Tax Assessment Act 1997* (Cth)

(i) 50% of the capital gain can be reduced – the **50% Active Asset Reduction**;[22]

(ii) up to $500,000 of the remaining capital gain can be contributed directly into superannuation – the **Retirement Exemption**;[23] or

(iii) any capital gains be delayed by up to 2 years if no replacement asset is acquired – the **Small Business Roll-over**.[24]

5.9 Practically, in the circumstance where the 15-Year Exemption is not available, the small business CGT concessions allows a single business owner to reduce:

(a) in the case of a capital gain made by a company – a $1 million capital gain to zero;[25] and

(b) in the case of a capital gain made by a discretionary trust holding the sale asset for at least 12 months – a $2 million capital gain to zero.[26]

5.10 Given the potential savings (including no CGT payable on a capital gain made by an entity eligible for the 15-Year Exemption), the small business CGT concessions are often seen as the payout for business owners who often focused solely on their business during their working career (potentially at the detriment of investing on passive investments and superannuation).

Small business CGT concessions – accessing the concessions – basic conditions

5.11 Section 152-10(1) *Income Tax Assessment Act 1997* (Cth) requires the following basic conditions to be satisfied before an entity (referred to as the **taxpayer** for this section) is eligible to access the SBCGT Concessions:

(a) a CGT event happens in relation to a CGT asset of yours in an income year;

(b) the event would (apart from the SBCGT Concessions) have resulted in the gain;

(c) ***at least one*** *of the following applies:*

(i) the taxpayer is a small business entity for the income year; (the **Turnover Test**)

(ii) the taxpayer satisfies the maximum net asset value test; (the **MNAV Test**)

(iii) the taxpayer is a partnership that is a small business entity for the income year and the CGT asset is an interest in an asset of the partnership; or

(iv) the conditions mentioned in subsection (1A) or (1B) (of 152-10 Income Tax Assessment Act 1997) are satisfied in relation to the CGT asset in the income year; and

(d) *the CGT asset satisfies the active asset test.* (the **Active Asset Test**)

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[22] Subdivision 152-C *Income Tax Assessment Act 1997* (Cth)
[23] Subdivision 152-D *Income Tax Assessment Act 1997* (Cth)
[24] Subdivision 152-E *Income Tax Assessment Act 1997* (Cth)
[25] $1 million capital gain reduced by 50% (due to the 50% Active Asset Reduction). The remaining $500,000 can be directly contributed into superannuation (due to the Retirement Exemption).
[26] $2 million capital gain reduced by the 50% general CGT discount in Subdivision 115-A *Income Tax Assessment Act 1997* (Cth). The remaining $1 million capital gain reduced using the 50% Active Assdet Reduction and Retirement Exemption.

5.12 In addition to the above conditions, if the asset being sold is a share in a company or an interest in a trust, then section 152-10(2) Income Tax Assessment Act 1997 (Cth) requires the following tests to be satisfied in relation to that company or trust (**object entity**):

(a) *the CGT asset would still satisfy the active asset test (see section 152-35) the assumptions in subsection (2A) were made;*

(b) *if you do not satisfy the maximum net asset value test (see section 152-15) – you are carrying on a business just before the CGT event;*

(c) *either:*

(i) the object entity would be a CGT small business entity for the income year; or

(ii) the object entity would satisfy the maximum net asset value test (see section 152-15);

If the following assumptions were made:

(iii) the only CGT assets or annual turnovers considered were those of the object entity, each affiliate of the object entity, and each entity controlled by the object entity in a way described in section 328-125;

(iv) each reference in section 328-125 to 40% were a reference to 20%;

(v) ao determination under subsection 328-125(6) were in force;

(d) just before the CGT event, either:

(i) you are a CGT concession stakeholder in the object entity; or

(ii) CGT concession stakeholders in the object entity together have a small business participation percentage in you of at least 90%.

5.13 Much of the additional requirements in section 152-10(2) *Income Tax Assessment Act 1997* (Cth) were inserted as part of the 2017-2018 Federal Budget as some taxpayers were able to access the small business CGT concessions for assets which were unrelated to small businesses (for example, through arranging their affairs so that ownership interests in larger businesses did not count towards the tests for determining eligibility for the concessions).

5.14 This was largely possible due to the 40% threshold for grouping related entities as part of the Turnover Test and MNAV Test.

Small business CGT concessions – accessing the concessions – Turnover Test and MNAV Test

5.15 Provided a capital gain arose in relation to a relevant CGT asset,[27] either the Turnover Test **or** MNAV Test must be met in order to potentially be eligible for the concessions.

5.16 Both tests effectively ensure the concessions can only be applied to 'small businesses', being:

(a) businesses with a total yearly aggregated turnover of $2 million (the Turnover Test); or

(b) businesses with total aggregated assets of $6 million (the MNAV Test).

Turnover Test

[27] For example, the small business CGT concessions would not apply to depreciating assets or trading stock due to sections 118-24 and 118-25 *Income Tax Assessment Act 1997* (Cth) respectively

5.17 In order to satisfy the Turnover Test, the taxpayer must:[28]

(a) carry on a business in the relevant income year; and

(b) one or both of the following applies:

(i) the taxpayer carries on a business in the previous income year and its aggregated turnover was less than $2 million; or

(ii) the taxpayer's aggregated turnover for the current income year is likely to be less than $2 million.

5.18 Please note that although section 328-110 *Income Tax Assessment Act 1997* (Cth) refers to a $10 million limit for the turnover, section 152-10(1AA)(b) *Income Tax Assessment Act 1997* (Cth) states that references to $10 million in section 328-110 should be read as $2 million for the purposes of small business CGT concessions.

5.19 The taxpayer's aggregated turnover is calculated on the annual turnover of the taxpayer and any entity that is an 'affiliate' or 'connected with' the taxpayer.

5.20 Section 328-120 *Income Tax Assessment Act 1997* (Cth) provides the meaning for 'annual turnover' which is the total ordinary income that an entity derives in an income year in the ordinary course of carrying on a business. Please note that non-assessable non-exempt income is excluded from such calculation. There are also rules that relate to amounts derived from dealing with associates that will need to be considered.

5.21 An overview on what it means to be an 'affiliate' or 'connected with' will be provided below.

MNAV Test

5.22 The taxpayer satisfies the MNAV Test,[29] if just before the CGT event, the following does not exceed $6 million:

(a) net value of the CGT asset of the taxpayer;

(b) net value of the CGT assets of any entities connected with the taxpayer; and

(c) the net value of the CGT assets of any affiliates of the taxpayer or entities connected with the taxpayer's affiliates (not double counting assets already counted under paragraph (b) above).

5.23 Net value of the CGT assets is defined to be the amount obtained by subtracting the sum of the market values of the assets of the following:

(a) liabilities of the entity that are related to the assets; and

(b) the following provisions made by the entity:

(i) annual leave;

(ii) long service leave;

(iii) unearned income; and

(c) tax liabilities.[30]

Meaning of 'affiliate' and 'connected with'

[28] Section 328-110 *Income Tax Assessment Act 1997* (Cth)
[29] Section 152-15 *Income Tax Assessment Act 1997* (Cth)
[30] Section 152-20 *Income Tax Assessment Act 197* (Cth)

5.24 Section 328-130 *Income Tax Assessment Act 1997* (Cth) states that an entity can only be an *affiliate* of a taxpayer if:

(a) the entity is either an individual or a company; and

(b) that individual or company carries on a business in their own right; and

(c) in carrying on that business, the individual or company does so either

(i) at the direction of the taxpayer; or

(ii) in concert with the taxpayer.

5.25 Section 328-125 *Income Tax Assessment Act 1997* (Cth) provides that an entity is connected with another entity if:

(a) either entity is controlled by the other; or

(b) each entity shares a common controller.

5.26 The meaning of control is specifically set out in the legislation and includes different tests for determining control of different types of entities. Broadly, however, having a 40% share of the decision making or equity is sufficient to be deemed as control for the purposes of this section. In the case of a discretionary trust, historical distributions of income and capital are considered in determining the 40% control threshold.

5.27 Including 'affiliates' and entities 'connected with' the taxpayer in the Turnover Test and MNAV Test is intended to ensure the concessions are available only to 'small businesses' and those taxpayers with both substantive assets and significant turnovers are denied the concessions.

Small business CGT concessions – accessing the concessions – Active Asset Test

5.28 The Active Asset Test is satisfied under section 152-35(1) *Income Tax Assessment Act 1997* (Cth) if:

(a) the taxpayer has owned the asset for 15 years or less and the asset was an active asset of the taxpayer for a total of at least half of the period which it was owned; or

(b) the taxpayer has owned the asset for more than 15 years, and the asset was an active asset for at least 7.5 years of the period.

5.29 Section 152-40 *Income Tax Assessment Act 1997* (Cth) states that a CGT asset will be an active asset if:

(a) it is used in the course of carrying on a business; or

(b) if the asset is an intangible asset – it was owned by the taxpayer and it is inherently connected with a business that is carried on by the taxpayer, or an entity connected with the taxpayer. This includes goodwill.

5.30 Shares in a company will be considered an active asset if:

(a) the share is in a company that is an Australian resident; and

(b) the total of:

(i) the market values of the active assets of the company; and

(ii) the market value of any financial instruments of the company that are inherently connected with the business that the company carries on; and

(iii) any cash of the company that is inherently connected with the business,

is 80% or more of the market value of all of the assets of the company.[31]

5.31 Where the asset being sold are shares or units, then the additional requirements of 152-10(2) *Income Tax Assessment Act 1997* (Cth)[32] must also be satisfied. These additional requirements can be summarised as:

(a) testing that the object entity is in fact a small business – which is made possible due to the broadening of the affiliate and connected with rules by reducing the control threshold from 40% to 20%;

(b) requiring an MNAV Test to be satisfied – that is, satisfying the Turnover Test is not sufficient if you are selling shares in a company or units in a unit trust;

(c) ensuring the person selling the shares or units is a 'key person' in the business.

Small business CGT concessions – benefitting from the concessions

5.32 Once the above tests have been satisfied, the small business CGT concessions may be available.

5.33 Certain exemptions, such as the 15-Year Exemption and Retirement Exemption, requires additional tests to be met that may differ depending on if shares in a company or the underlying business assets are sold.

5.34 At a minimum, the 50% Active Asset Reduction will be available to reduce any capital gains by 50% (provided the 15-Year Exemption is not applied).[33]

15-Year Exemption

5.35 The 15-Year Exemption allows a taxpayer meeting the basic conditions and certain additional conditions to disregard 100% of a capital gain arising from the sale of a CGT asset where that asset has been owned by the disposing taxpayer for at least 15 years.

5.36 Additional conditions such as requiring the taxpayer to have held the CGT asset for at least 15-years and for there to be a 'key person' will also need to be met.[34]

5.37 Crucially, however, in order to apply this exemption, the 'key person' must be over 55 and show that the transaction will occur in connection with that person's retirement.

5.38 Please note that whether an event occurs 'in connection with that individual's retirement' will depend on the particular circumstances of each case. Commentary from the Tax Office indicates that there should be a significant reduction in the number of hours the individual works, or for there to be a significant change in the nature of their present activities.

5.39 Where possible, this exemption should be sought as it allows for the entire capital gain to be distributed tax-free from the business entity to the 'key-person' as 'non-assessable non-exempt income'.[35]

Retirement exemption

5.40 Under the Retirement Exemption,[36] a taxpayer can disregard up to $500,000 in capital gains for a 'key person'.

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[31] Section 152-40(3) *Income Tax Assessment Act 1997* (Cth)
[32] See paragraph 5.12 above
[33] Section 152-205 *Income Tax Assessment Act 1997* (Cth)
[34] Section 152-10 *Income Tax Assessment Act 1997* (Cth)
[35] Section 152-125 *Income Tax Assessment Act 1997* (Cth)
[36] Section 152-315 *Income Tax Assessment Act 1997* (Cth)

5.41 Section 152-325 *Income Tax Assessment Act 1997* (Cth) requires a taxpayer to make the disregarded amount to the 'key person'. If the 'key person' is under the age of 55 years, then such payment must be made to a complying superannuation fund.[37]

Small business CGT concessions – trap for companies applying the concessions

5.42 Where companies are able to apply the above concessions, there can be circumstances where there is difficulty in extracting the proceeds.

5.43 This is because, where there are tax-sheltered proceeds received by the company that are not extracted due to the operation of any other provision,[38] no franking credits would be made available to such amounts (as no company tax was paid). Relevant proceeds can include such capital gain reduced by the 50% Active Asset Reduction.

5.44 Extracting such amounts would generally result in an unfranked dividend being triggered.

5.45 The general strategy to extract the sheltered amount, therefore, requires a liquidator's distributions.

5.46 Generally, payments to shareholders by liquidators can generally be treated as follows:

(a) taxed as a dividend (with franking credits attaching if available);

(b) taxed as a capital payment (and subject to capital gains tax); or

(c) received tax free.

5.47 For a company having benefited from the 50% Active Asset Reduction, the distribution of such amount will not be considered as having been received tax free – it is non-assessable income.

5.48 Whether such non-assessable amount will be taxed as a dividend or as a capital payment will depend on whether it falls within section 47 *Income Tax Assessment Act 1936* (Cth).

Taxed as a dividend?

5.49 Section 47 *Income Tax Assessment Act 1936* (Cth) is extracted below.

(1) Distributions to shareholders of a company by a liquidator in the course of winding-up the company, to the extent to which they represent income derived by the company (whether before or during liquidation) other than income which has been properly applied to replace a loss of paid-up share capital, shall, for the purposes of this Act, be deemed to be dividends paid to the shareholders by the company out of profits derived by it.

(1A) A reference in subsection (1) to income derived by a company includes a reference to:

(a) an amount (except a net capital gain) included in the company's assessable income for a year of income; or

(b) a net capital gain that would be included in the company's assessable income for a year of income if the Income Tax Assessment Act 1997 required a net capital gain to be worked out as follows:

[37] Section 152-325(7) *Income Tax Assessment Act 1997* (Cth)

[38] For example, the 15-Year Exemption provides for the extraction of the proceeds as non-assessable non-exempt income

Method statement

> *Step 1. Work out each capital gain (except a capital gain that is disregarded) that the company made during that year of income. Do so without indexing any amount used to work out the cost base of a CGT asset.*
>
> *Step 2. Total the capital gain or gains worked out under Step 1. The result is the net capital gain for that year of income.*

(2) Those distributions shall, to the extent to which they are made out of any profits or income, be deemed to have been paid wholly and exclusively out of those profits or that income.

(2A) Where:

(a) the business of a company has been, or is in the course of being, discontinued otherwise than in the course of a winding up of the company under any law relating to companies;

(b) in connexion with the discontinuance, any moneys of the company have been or other property of the company has been, on or after 19 October 1967, distributed, otherwise than by the company, to shareholders of the company; and

(c) the moneys or other property so distributed are not, for the purposes of this Act, dividends;

the distribution shall, subject to subsection (2B), be deemed to be, for the purposes of this section, a distribution to the shareholders by a liquidator in the course of winding up the company.

(2B) Where:

(a) subsection (2A) would, but for this subsection, apply in relation to any moneys or other property of a company distributed to shareholders of the company; and

(b) the company does not cease to exist within a period of 3 years after the distribution, or within such further period as the Commissioner allows;

subsection (2A) shall not apply, and shall be deemed never to have applied, in relation to those moneys or that other property, and those moneys or that other property so distributed shall, for the purposes of this Act, be deemed to be dividends paid by the company to the shareholders out of profits derived by it.

*(3) For the purposes of this section, **paid-up share capital** includes capital which has been paid up in money or by other valuable consideration and which has been cancelled and has not been repaid by the company to the shareholders.*

5.50 Importantly, income derived by a company will include net capital gains assessable to the company.

5.51 In this regard, TD 2001/14 confirms that a distribution by a liquidator of an amount subject to the 50% Active Asset Reduction under 152-205 *Income Tax Assessment Act 1997* (Cth) is not deemed to be a dividend under section 47 *Income Tax Assessment Act 1936* (Cth) – paragraph 1 TD 2001/14.

5.52 It would therefore be required to consider the tax consequences as such payment will be:

(a) treated as a capital payment;

(b) subject to CGT; and

(c) able to have the small business CGT concessions applied again to reduce capital gains.

6 Family business succession planning factors

Academic literature

6.1 Succession planning for family businesses offers unique issues not considered as part of non-family businesses.

6.2 There has been a rise in academic literature[39] relating to a concept of 'socioemotional wealth' (or '**SEW**') and its influence in the decisions made by family businesses.[40]

6.3 SEW has been defined as the *'non-financial aspects of the* [business] *that meet the family's affective needs, such as identity, the ability to exercise family influence, and the perpetuation of the family dynasty'*.[41]

6.4 To put simply, family businesses need to manage the 'family' aspects and issues that come with having family involved in the ownership and management of the business.

6.5 Whilst non-family businesses merely need to balance the relationship between management (those making the day-to-day decisions) and ownership (those who benefit from the growth in the business); family businesses also need to consider the impact decisions at the management and ownership level could have on family standing both internally and to the wider community.

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[39] However, the literature acknowledges the early nature of such research and theories

[40] The author has specifically considered the following research and papers in relation to this concept of 'SEW' is largely influenced by the information read: Gavin J Nicholson, "Succession Planning Management (SPM): A Case Study of Vietnamese Family Owned Business in Australia" Submitted in fulfilment of the requirements for the degree of Doctor of Business Administration (DBA) Victoria University Graduate School of Management College of Business; Matias Kalm and Luis R. Gomez-Mejia, "Socioemotional wealth preservation in family firms" Revista de Administracao 51 (2016) 409-411; Qing Lan, "Understanding Socioemotional Wealth – Examining SEW and Its Effect on Internationalization" May, 2015 as part of a Master's thesis within Business Administration of Jonkoping International Business School; David Devins and Brian Jones, "Review of Family Business Research on Succession Planning in the UK" ERASMUS+ KA2 Strategic Partnership 2014-1-HUO1-KA200-002307 ;Helge Mensching, Sascha Kraus, Ricarda B. Bounchken, "Socioemotional Wealth in Family Firm Research – A Literature Review" JIB, Volume 14, Number 4 2014.

[41] P Berrone, C Cruz, L.R Gomez-Meija, "Socioemotional Wealth in Family Firms: Theoretical Dimensions, Assessment Approaches , and Agenda for Future Research" *Family Business Review,* 25(3), 258-279 – It has been proposed that SEW could be broken down into five preferences (**FIBER**), namely (1) **f**amily control and influence; (2) **i**dentification of family members within the firm; (3) **b**inding social ties; (4) **e**motional attachment; and (5) **r**enewal of family bonds to the firm through dynastic succession

6.6 It has been suggested that '*family* [businesses] *are typically motivated by, and committed to, the preservation of SEW*'.[42] This means that decisions in family businesses are often made to maximise:

(a) a family's control and influence in the business;

(b) the identification of family members involved in the business;

(c) the potential to exert the family's name within social ties and the broader community;

(d) emotional attachment of the family in the business; and

(e) the prolonging of the 'family dynasty',

even (potentially) to the detriment of the business financially.

6.7 Examples of the effect SEW may have on certain business decisions are listed below in comparison to potential decisions that non-family businesses *could* make.

Family business	***Non-family business***
Picking family members into leadership roles in the business regardless of experience as it maximises the identification of family members in the business and family control	Picking a person (whether family or not) with the most suitable qualifications into leadership roles, whether internally (from the business) or externally
Family member executives deciding to proceed with risk adverse strategies to maintain the family wealth[43]	Directors deciding to proceed with strategies to maximise potential returns
Family businesses choosing to self-finance transactions to ensure control is retained within the family	Non-family businesses may seek financing via debt financing or equity participation from non-family members to undertake any large-scale transactions
Family businesses choosing to 'avoid taxes less aggressively than nonfamily' businesses out of fear of the negative outcomes associated with aggressive tax avoidance[44]	Management seeking strategies that can maximise profits to the owners (to validate the appointment of such persons in management positions)
Family businesses 'sticking by' underperforming family member executives either due to fear of repercussions within the family dynamic or due to the fact that such executive is earning less than what a non-family member executive would have earnt	Non-family member executives more easily criticized and dismissed if underperforming

[42] Ibid

[43] Family businesses may alternatively be willing to take large financial risks to mitigate losses on their socioemotional wealth

[44] S. Chen, X. Chen, Q. Cheng and T. Shelvin (2010), "Are family firms more tax aggressive than non-family firms?" *Journal of Financial Economics*, 95(1), 41-61

Lack of written documents and evidence maintained due to the trusting nature of family members	Formal documents and processes implemented to provide a record of decision making

6.8 Additionally, social, economic, political and cultural factors can further impact the decisions and processes in a family business. For example, literature has suggested that Anglo family businesses in Australia tend to excel in business performance and individualism, with moderate business longevity. In contrast, Asian family businesses were found to focus on family and collectivism.[45] It was also acknowledged the superstition against discussing death and finality found in Asian culture resulted in Asian family businesses having a lack of succession planning or focus.

6.9 As may be identified, decisions made by family businesses can often be driven by emotion rather than rational thinking. Therefore, the input of independent advisors cannot be underestimated in ensuring family businesses are advised in a balanced and non-biased manner.

Family business succession questions

6.10 Fundamentally, the crucial questions that need to be asked of the family can be summarised as follows:

(a) *What is the long-term vision of the ownership in the family business? Specifically, who should take ownership of the business after the current family head leaves?*

(b) *How should decisions in relation to the family business be made in the future to ensure the longevity of the family business? Specifically, should there be a framework implemented to require certain people to 'approve' or be in the majority of decisions being made in the family business?*

(c) Are there any family issues or concerns that can affect the implementation of the above intention?

What is the long-term vision of the ownership in the family business?

6.11 The information sought from this question is to effectively understand who should benefit from the operations of the family business:

(a) once a parent exits the business;

(b) once both parents have exited the business; and

(c) for the next generation or two down the line.

6.12 Families should consider if any of the following outcomes are ones that they are looking to achieve for their family business:

(a) the family business to be managed for the benefit of a surviving spouse;

(b) the family business to be managed for the benefit of a child or children involved in the business, whether that be:

(i) equally; or

(ii) disproportionately;

[45] D. Waddel, M. Parris, J. Ye (2013), "The succession decision in Chinese-Australian family businesses: An exploratory study", *Small Enterprise Research*, vol. 20, p.110-125

(c) the family business to be managed for the benefit of the broader family (i.e. all children) despite only having some of the children involved, whether that be:

(i) equally;

(ii) disproportionately; or

(iii) in a manner determined by key family members;

(d) the family business be sold to particular family members at market value (as opposed to being passed down under a succession plan);

(e) the family business be sold to key employees or third parties in the business at market value; or

(f) the family business to be wound up on the family head's exit.

6.13 Where the family business is a 'partnership' between siblings or a combination of family members (each considered a separate **Family Branch**), the questions need to be considered holistically by all Family Branches and whether all other Family Branches are in agreement.

6.14 Further, the traditional business succession planning issues may also need to be considered given separate 'partners' (despite the parties being family) such as:

(a) whether an exiting family member will transfer their share in the family business to the remaining family member/s; and

(b) how such a transfer will be funded (e.g. whether the remaining family member/s must fund third party financing to pay out the exiting family member, whether the use of a buy sell deed is appropriate, or whether the transfer occurs for no consideration given the close family relationship).

Example

A family business operates various sea vessels. The business is owned by two brothers (Adam and Ben) as equal owners (through their family trusts in a partnership).

Both brothers will need to consider what happens to their respective share in the business regarding who takes ownership in the event either one or both of them lose capacity or pass away (**Default Event**).

Adam has three sons involved in the operation of the business, while Ben has one son who is not involved in the business.

Scenario 1

Adam and Ben agree that on a Default Event occurring to Ben, Adam (or Adam's sons) will 'buy-out' Ben.

The 'buy-out' can be way of finding bank financing or through a self-funded insurance buy sell deed.

Scenario 2

The two families enjoy a close relationship and it is agreed that it is in the best interest to keep the two Family Branches involved with each other.

Steps are taken to introduce Ben's son in the business and in a position to succeed Ben on the occurrence of a Default Event.

Documents are also implemented to ensure each family member in the second generation receives an equal share in the business and in a manner that reduces a potential abuse of power by Adam's three sons holding a majority interest in the business.

Informal documents are also prepared to ensure Adam and Ben's respective spouses continue to benefit from the family business in the same manner as if Adam and Ben were in control.

6.15 Further complications can arise when the intention is for certain 'subsidiaries' or business branches/assets to pass to specific family members, especially where the family business is not operated through a suitable structure.

Example

A family business operates various businesses selling tyres and autocare services, effectively creating a brand through the State.

The business is operated through a discretionary trust by the father (Carl).

Carl has three sons who are all involved in the family business.

As Carl is too old to continue managing the business, Carl wishes to step down and pass control of the business to his three sons.

Unfortunately, in this case, Carl's three sons do not get along and as a result various stores must be transferred into separate structures controlled by each of the sons at significant stamp duty and CGT costs.

Comments

This example (which is inspired from the facts of a payroll tax case) is an example of a family business not having an appropriate succession plan in place.

If a succession plan was considered and it was found that the sons would be unable to work together, then the question on how to separate various stores in the business and set them aside for the relevant son would be appreciated and appropriate strategies implemented prior to the transition (even if to just manage the adverse tax consequences).

6.16 Understanding a family's intention in relation to the ownership of the family business will provided clarity on:

(a) whether the current succession planning arrangements for the family is sufficient to achieve the family's intention;

(b) whether the current structure of the family business is appropriate to achieve the family's intention; and

(c) what is the best structure to achieve the family's intention for the family business?

How should decisions in relation to the family business be made in the future to ensure the longevity of the family business?

6.17 Although it is critical to ensure ownership in the family businesses passes for the benefit of the intended family members, studies have shown that businesses in which the CEO (e.g. the family head) has a specific successor in mind tends to be more successful than other businesses.[46]

[46] F. De Visscher (2004), "Balancing capital, liquidity and control", available at http://www.devisscher.com, accessed September 2019

6.18 Therefore, the success of a 'family dynasty' will largely rely on those involved with making decisions in the future for the family business

6.19 While this question looks to draw out the current family head's intention and opinion regarding who should succeed as the family head, there are various ancillary issues that should also be considered at this juncture to ensure the transition to the new family head is appropriate and well managed.

6.20 These ancillary issues can include:

(a) who the successor family head will be;

(b) whether the successor family head/s will be one or more people;

(c) whether other persons should be appointed as a director with the family head;

(d) whether there should be qualifications required prior to a person being appointed as a director;

(e) whether key non-family employees or independent advisors should be involved in the decision-making process and appointed as a director;

(f) whether the knowledge of the existing family head has been transferred to the successor (being the successor family head and/or directors) or how such knowledge can be transferred;

(g) whether the successor has been integrated and respected within the business (by employees) and key third parties (such as suppliers);

(h) whether the successor's values aligns with the family businesses values;

(i) when the transition to the successor should occur; and

(j) if a framework (whether informal or outlined in a legally binding or non-legally binding document) should be implemented in appointing successors that can survive the first transition of the family business.

6.21 As outlined above, family businesses often choose to appoint family members as 'CEO's of the business. This decision can be made regardless of whether such a family member has the appropriate qualifications or experience to fulfil this role.

6.22 While such a decision may be seen (independently) to be inappropriate, the role of advisors to the family business should be focused on ensuring the chosen successor has the appropriate support systems and processes in place to succeed.

6.23 While this may simply be achieved by having the chosen successor 'shadow' and learn from the current CEO by making direct decisions that can impact the business, it can be extended to having key advisors involved with the decision making (whether it be informal or legally embedded in a document) for the successor.

6.24 Understanding a family's intention in relation to who should be responsible for directing the family business will provided clarity on:

(a) what can be done today to allow for the transition to be as smooth as possible;

(b) whether arrangements or documents need to be prepared to assist with the transition by establishing support systems and processes; and

(c) whether thought has been considered in relation to putting in place a framework for future generations to work with.

Are there any family issues or concerns that can affect the implementation of the above intentions?

6.25 Existing studies have already outlined how 'the family factor' can influence the decisions of a family business in unexpected manners. It is therefore crucial to properly understand the 'family factor' relating to each family business as no two families will be the same.

6.26 Given the personal nature of family dealings, questions and issues that are often considered as part of a personal estate plan will also be relevant for the succession plan of a family business.

6.27 These questions and issues can include:

(a) family members having an issue with the business succession plan, which can arise:

(i) when a family member working in the business is left with less than what they expected;

(ii) where a promise was made to a family member to receive more of the family business than was received;

(iii) where certain family members are passed up from leadership or directorship roles in favour of other family members;

(iv) due to 'rivalry' issues between family members; or

(v) due to some family members feeling like they do more in the business than others (and they have accordingly not been appropriately acknowledged or appreciated);

(b) concern of certain 'step-family' or children-in-laws negatively affecting the direction and performance of the business;

(c) whether separate Family Branches are able to work with each other for the family as a whole;

(d) issues in being direct with failings within key family members;

(e) a lack of clear communication lines (or 'workability') between the family members involved in the family business (those in 'Management') and those reaping the benefit (the 'Owners');

(f) 'buried' family arguments arising once the older generation has left the picture;

(g) the asymmetrical influence, power and views between generations which can result in:

(i) older generations choosing not to transition day-to-day decision making to younger generations at the right juncture;

(ii) older generations not valuing or considering opinions from younger generations; or

(iii) younger generations keeping with the 'status quo'; and

(h) the lack of the family retaining appropriate documentation of key decisions and resolutions; and

(i) failing to enforce an underlying family value that can outlast the generation.

6.28 Potential family issues in a family business succession plan can include:

(a) the father who had to protect the succession of the property management business he built for the benefit of his daughter, whilst in the middle of a matrimonial breakdown;

(b) the father and mother who needed to pass down the business to their three children with various issues between each child:

(i) one child took a lead role in the business and believed he deserved more from the business;

(ii) one child and her husband was involved in the business, but they were often considered as underperforming; and

(iii) one child who had nothing to do with the business (and thereby managing the sibling's feelings); and

(c) the father who had concerns that his eldest daughter and son-in-law would cause trouble in the family business until it was sold, and ensuring the right children of his took control of the business to build that 'family dynasty'.

6.29 What needs to be appreciated is that 'the family factors' and issues will continuously evolve as:

(a) family members who may have no involvement in the business may choose to start working in the business;

(b) estranged relationships can reconcile;

(c) existing relationships can sour due to disagreements; and

(d) family values and standings can change,

and as a result, a family business' succession planning must consistently be reviewed (even more than a business operated between non-family members).

Documentation required to align the ownership with the succession planning intentions of the family

Passing ownership in a company

6.30 As outlined above, ownership in a company rests with the members of the company.

6.31 In the circumstances of a company limited by shares, this means the shareholders are the owners.

6.32 The issue, therefore, is ensuring that shares in the company operating the family business, passes in a consistent manner with the family's intention.

6.33 In the event of putting in place appropriate documentation passing ownership:

(a) on the death of the current owner (or key person):

(i) where the shares are held by an individual, this means ensuring the current shareholder's Will is drafted in a manner that makes the shares (whether by way of a specific gift, or due to the overall structure of the beneficiaries under the Will) pass to the intended family members who will take ownership of the family business. Where it is not appropriate to have the shares pass via an individual's Will (due to a potential estate challenge as mentioned above), documents such as a shareholders agreement or call option agreement may be suitable in providing certainty for successor family members to obtain the relevant shares on the death of the individual;

(ii) where the shares are held by a trust, this means reviewing the succession of the trust on death and ensuring control and/or ownership in the trust passes to the intended family member. The succession of control and ownership in a discretionary trust will be discussed further below;

(b) on the loss of capacity of the current owner (or key person):

(i) where the shares are held by an individual, this means ensuring an appropriate enduring power of attorney document is prepared to allow the intended family members to make decisions on behalf of the current owner, as shareholder of the company (please note that the ability to make director decisions are not usually transferrable under an enduring power of attorney document);

(ii) where the shares are held by a trust, this means reviewing the succession of the trust on loss of capacity of the key person and ensuring control and/or ownership in the trust passes to the intended family member;

(c) during the lifetime of the current owner (or key person):

(i) shares (whether all or only a proportion) in the company can be transferred to the intended family members, with the current owner (or key person) retaining some proportion of shares;

(ii) call options over shares (whether all or only a proportion) in the company could be granted to the intended family members, with certain conditions precedents being met prior to such options being able to be exercised; or

(iii) where the shares are held by a trust, control in the trust can be diluted between the current key person and intended successor family members.

Passing ownership in a discretionary trust

6.34 As previously provided, practical ownership in a discretionary trust passes through the Trustee, and in the event there is an Appointor role in the trust, the Appointor.

6.35 This is notwithstanding the fact that the ultimate benefactors of the discretionary trust are the beneficiaries (as it is the Trustee of the discretionary trust who is able to decide which beneficiaries may benefit from the trust).

6.36 Appropriate documentation will therefore need to be put in place to ensure the underlying owner's control and therefore benefit from the discretionary trust pass as intended:

(a) in the circumstances where there is no Appointor role:

(i) a deed of change of trustee can be prepared to change or dilute the Trustee role while the current owner is involved in the business. This can either by way of appointing multiple individual trustees or appointing a company trustee with multiple directors. This can allow the intended family member to take control of the discretionary trust immediately on their own or jointly with the current owner; or

(ii) a deed of appointment of successor trustee can be prepared to automatically change the trustee on certain events occurring to the current trustee (such as death or loss of capacity). This document is usually prepared when a current owner is the individual trustee and wishes to continue having control in the family business until they lose their ability to make those decisions (such as on death or loss of capacity);

(b) in the circumstances where there is an Appointor role, much of the same documents mentioned above can be prepared specifically for those involved at the Appointor level. There will, however, be more flexibility when there is an Appointor role, as separate persons can be appointed into the Trustee and Appointor role (for example, the management of the discretionary trust can pass to the intended successor family head by way of the change of trustee, while the current family head can separately step into the Appointor role).

6.37 In the event when the trust already has a company as Trustee or Appointor, steps could just be taken to change the directorship and shareholding in that company accordingly.

Other factors

6.38 Where there are various structures in the family business, each structure and relevant role will need to be carefully reviewed and documentation prepared.

6.39 It may be that ownership of certain entities in the family business pass to certain family members with the other entities in the family business passing to the remaining family members.

Example

A company operates a business selling spare vehicle parts.

The company operates the business in a commercial warehouse owned by a related discretionary trust.

Mum and dad have two children (Jason and Jane) who are involved in the business.

It is mum and dad's intention that each child gets an equal share in the business. However, given that Jane is going to inherit a residential property under mum and dad's Will, it is their intention to pass the commercial warehouse (in which the business operates from) to Jason.

Mum and dad will need to ensure the shares in the company pass equally to Jason and Jane, and have control in the discretionary trust pass to Jason through a separate set of legal documents.

6.40 Separately, where there is a unit trust involved within the business structure, the succession planning issues considered for both companies and discretionary trusts will need to be considered as the underlying owners in a unit trust (in contrast to a discretionary trust) can be clearly identified through the unitholders (much like the shareholders in a company).

6.41 Thought should also be made in relation to any loans and/or unpaid present entitlements (**UPEs**) within the family group, and whether any existing loans/UPEs inadvertently shifts value away from intended persons (for example, the trading entity owing a large sum to the key individual of the business whereby certain children will take control of the trading entity, but all children will benefit equally under the key individual's Will).

6.42 Any succession planning documents implemented will, of course, need to be consistently reviewed and updated accordingly considering any changes with family dynamics.

Documentation required to align the decision-makers in the family business with the succession planning intentions of the family

6.43 A successful family business succession plan requires more than just ensuring ownership in the business passes to intended family members.

6.44 Without anything further guidance, nothing stops ill-informed family members with ownership interests from operating the business into the ground.

6.45 In other words, thought and consideration should be made in appointing appropriate persons into director roles in the family business.[47] In addition, a framework should also be put in place dictating who may be appointed into director positions further down the track and how such persons will be appointed into such capacity.

Transitioning today or tomorrow

6.46 An often-difficult task for family heads is to consider when to pass the decision-making in the family business down to the next generation. Current family heads may feel that they can keep going running the business through themselves or may just not be comfortable relinquishing control at this stage.

6.47 What may not be appreciated, however, is the longer a family head chooses not to pass key decision-making responsibility down to their successor, the more likely the successor may feel ill-prepared to take on the family head or director (a decision-maker) role.

6.48 It is imperative that steps are taken to integrate key future decision-makers into the business today, rather than tomorrow.

6.49 Doing so allows decision-making successors to learn and understand the operations of the family business, whilst having the 'safety net' of the knowledge and experience of the current family head.

6.50 Integrating the next generation now also allows them to contribute with potential improvements to the business process and system, based on their education and experiences.

6.51 Where it is not possible to integrate the future decision-makers into the business today, thought has to be given into implementing a transition plan that can allow an as smooth as possible hand-down at a later date.

6.52 For example, whereas an integrated decision-maker would have an opportunity to understand the family business through liaising with staff and key employees, a decision-maker thrown into the 'head' role would be left without any operational experience or understanding on how the business operates.

6.53 A potential strategy to manage this 'void' of understanding in the family business could be to establish a family council (whether formally or informally) in the business with key senior employees or family advisors (with an understanding of the business) to assist and advise the incoming successor/s.

Putting in place a framework

6.54 Whilst establishing the council informally may include nothing more than just verbally informing of the intention to the persons to be involved, setting out such intentions formally can include:

(a) having documents (such as family constitutions, company constitutions and/or shareholders agreements) drafted outlining:

(i) any named successor decision-makers;

(ii) the process to appoint successor decisions-makers;

[47] Studies have shown that a common trait of inadequate succession plans include founding fathers retiring without an appropriate successor considered – Rothwell, W.J., (2010), "Effective Succession Planning: Ensuring leadership Continuity and Building Talent from Within", American Management Association (AMACON), NY

(iii) any key persons to be involved in advising successor decision-makers, including:

(A) key employees involved in the business – who can assist with advising on the operational aspects of the family business;

(B) independent advisors – who can provide unbiased recommendations in the interest of the family business;

(iv) the process on how decisions must be made including:

(A) the voting power of decision-makers;

(B) any threshold percentage for decisions to be made;

(C) requiring certain persons to be in the majority for decisions or holding casting votes;

(D) limiting the ability for owners to override the decisions of the decision-makers;

(b) implementing additional documents to ensure the above framework cannot be overridden – for example, by ensuring any Appointor role in a trust is structured in a manner consistent with any trustee role which can include:

(i) amending the terms of the trust deed by replacing the Appointor terms; and/or

(ii) changing the Appointor role to align with the Trustee role including through the use of a company appointor (whether the company is the same company acting as Trustee or a new company with the same constitution terms).

Documentation to consider the 'family factor'

6.55 As identified above, appreciating the 'family' factor cannot be underestimated in considering the success of a family business succession plan.

6.56 Without adequate consideration, historical issues or future potential divisions may go unnoticed. For example:

(a) past disagreements between family members may arise and cause division at the ownership or management levels of the family business;

(b) family members may also be unhappy with:

(i) any difference between ownership in the family business with other family members;

(ii) having to provide a continued income stream to the retired heads of the family;

(iii) not being involved with the management of the family business;

(iv) being involved with the management of the family business, but only having an equal share in the ownership (i.e. '*why should I grow the business if I do not receive proportionately more from my efforts?*');

(c) family members may also disagree with the strategic direction the family business is heading, which can be due to various factors such as:

(i) aligning the family business with certain people in a manner that does not reflect the family values;

(ii) shifting the general operations of the business in a manner that does not reflect the family values; and

(iii) an unbalanced shift in the management of the business within family sub-groups.

6.57 It is, however, impossible for current family heads to predict or foresee all the potential fallouts that may occur within the family, so rather than attempting to cater to the potential scenarios, a framework can be put in place within the family.

6.58 This 'framework', known as a 'family constitution' (if in writing) or a 'family council' (if relayed through a group of family members), can be developed to provide a mechanism in allowing family members to assess the conduct of those members in the management of the family business against the overarching values that the family should uphold.

6.59 Although there is no standard framework, such arrangements can often include the following:

(a) a general statement reflecting the vision and values of the family (often decided by the current family heads);

(b) an overview on the intentions and recommendations of the current family heads in the direction of where they would like the family business to go;

(c) an overview on how the current family heads foresee the family unit working together in maintaining and growing the family business;

(d) a list of values that the family unit should strive to achieve and pass down for future generations;

(e) information about how and when non-management family members can review the financial position of the family business, and express their opinions and view to those family members involved at management level; and

(f) how family members can resolve disputes (whether using independent advisors or mediation) and confidentiality concerns.

6.60 While it may be tempting to have the above framework undocumented and left as an unspoken rule within the family, the documenting and commitment to be bound by such document between all relevant family members will go a long way in reducing potential disputes later.

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9 Disclaimer

9.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

10 Contact details

Author	Darius Hii, Director
Firm	Chat Legal Pty Ltd ABN 64 621 391 553
Direct line	0403 923 374
Email	darius@chatlegal.com.au