BUSINESS SUCCESSION PLANNING PRINCIPLES

By

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Where do you start?

This is the most common question asked and the most common excuse given to avoiding embracing business succession planning.

The comments below represent a "grab" of ideas and issues which will help you to start. By no means should these be considered the last or definitive word on business succession planning, as you become more involved in the process you will agree that there is no answer to that eternal question "how long is a piece of string?"

What should you do?

I invite you to begin the process at whatever point you feel most comfortable with. This of course depends on your relative position; whether an adviser, a son or daughter or business partner.

What is business succession planning?

Business succession planning involves identifying objectives and strategies to deal with management succession and ownership succession which are designed to ensure a smooth transition for the business and ensure its continued profitability.

In addition, it will often be relevant when developing business succession planning strategies to distinguish between family businesses and non-family businesses.

Family businesses may, very broadly, be described as businesses where control and management is held within a distinct family unit. Often, but not always, the succession planning objectives for businesses of this nature will involve the business passing to the next family generation.

Non-family businesses are, broadly, those businesses where control and ownership are held by unrelated persons or entities, perhaps by several distinct family units.

As always, the key to successful business succession planning is to understand the business and the objectives of the business principals. This involves an understanding of the type of business involved, the types of structures involved, the identity of the relevant owners of the business and the key people involved in the business.

The tools involved in a successful business succession plan can include personal estate planning documents (such as Wills), buy/sell agreements, powers of attorney, documents dealing with management succession, documents dealing with ownership succession, family business charters, general business plans and other relevant documents. Naturally enough, a business succession plan may include one or more of these documents reflecting various complimentary strategies.

Management Succession Issues

Implementing a successful management succession planning strategy for a business can involve the following issues:

- Identifying the management successors. This may be the second generation or it may be the existing business managers, or it may be other key personnel not currently in a management role.

- Identifying the skills currently existing in the designated business management successors. This would include determining the training needs (if any) for those designated persons having regard to the future direction for the business. For example, if a designated business successor wants to take the business into a new area, the skill base required for the management team in going into that new area may be quite different to that which currently exists.

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- Appropriate use of external directors to supplement skills of existing directors and to provide additional levels of experience and expertise as well as an external ("non-family") perspective.

- Establishing the rules for involvement in the management of the business including aspects of promotion, salary, areas of responsibility and the like. This is particularly important where family members may be involved in the business, because their progression through the business needs to depend not only on their status as a family member.

- Particularly for family businesses governed by a matriarch or patriarch, it is often prudent to establish a board of management during the lifetime of that matriarch or patriarch in order to achieve all of the objectives outlined above.

- A plan may need to be developed for the relinquishing of responsibility of the matriarch or patriarch. Commonly referred to as "knowing when to let go", this strategy can often be critical in ensuring smooth transition and succession of management, by ensuring that the time at which designated business successors are promoted to desired levels of responsibility takes place when it is desirable not only for the designated business successor, but also at a time that is in the best interests of the business.

- Developing a plan for the on-going relationship between designated management successors and other staff (particularly non-family staff) of the business so as to ensure continuity of service of valuable employees.

- Identifying the objectives of the designated management successors and whether their objectives will involve significant shifts in the direction of the business. Clearly this could involve changes in business structure, significant expenditure on infrastructure in embarking into new markets and the development of appropriate expertise, structures and systems suitable to achieving these objectives.

Ownership Succession

Ownership succession for a business involves determining the most appropriate strategy to transfer the ownership of business interests to designated business successors. Again, the identification of these designated business successors is critical.

A range of strategies can be used to achieve ownership succession. Often a combination of these will be appropriate. For example, typically the following strategies are useful in ownership succession for businesses:

- transfers through Will;

- buy/sell agreements;

- creeping relinquishment of ownership by a matriarch or patriarch and corresponding creeping acquisition of ownership by a designated business successor;

- use of employee share acquisition plans and other incentive arrangements.

Typical events that need to be planned for are the following:

- death of a business owner or business principal;

- the disablement of a business owner/principal;

- the retirement of a business owner/principal;

- the resignation of a business owner/principal;

- the business owner/principal winding down their active involvement in the business;

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- the bankruptcy of a business owner/principal.

In appropriate circumstances due consideration should also be given to the sources of funding for any transfer of ownership interests in the business that will take place as part of the business succession plan.

Where business interests are to be transferred between generations in the one family unit, due consideration needs to be given to whether the change in control should take place during the lifetime of the existing business owner or under the Will of the existing business owner (assuming they own their interests) personally. Clearly, where business interests are owned by family trusts or other entities, then thought will need to be given as to the control of that family trust and how to ensure that the designated business successor is in a position to control the business by controlling the family trust.

What Are the Buy\Sell Structures?

Usually when business partners are forced to look at creating a buy/sell agreement, their views as to how it should be structured vary greatly. Not only must there be some consensus as to what events will trigger the buy\sell arrangement, the actual buy\sell structure must also be agreed upon.

- A good buy\sell agreement:
- Is drafted in view of the governing rules of business, eg. trust or partnership deed or articles of association.
- Is flexible to allow for entry and exit of partners.
- Is simple to understand and drafted in plain English.
- Establishes a clear and precise sequence of events necessary to transfer the business.
- Avoids stamp duty and capital gains tax concerns.
- Establishes the timing - i.e. how soon after death the transfer must occur.
- Recognises the need for funding - i.e. will life insurance be obligatory? Will the purchasers be given time to pay after death?
- Essentially five methods exist:
- In-principle heads of agreement.
- Mutual wills.
- Conditional contract.
- Exchange of options.
- Share buy-backs.

Heads of Agreement

No-one ever intends the in-principle heads of agreement approach - at least, no thinking person does. This usually occurs because the parties thought about it, reduced their thoughts to writing and then did nothing. And nothing is what they got.

Mutual Wills

Where the partners have very strong personal relationships, the mutual wills approach has often been adopted -

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"in my will, I gift to you my half of the business and in your will, you do the same."

Usually each deceased estate is "compensated" for the value of the business through life insurance owned by the deceased but paid for by both parties. The result is a very simple cost-effective buy\sell arrangement.

What are the pitfalls for a mutual will?

Your major pitfall is that one might change their will. While rights in contract exist, you need to seek legal advice and take action to enforce your contractual rights. And you will not know it has been done until death.

Also consider the view expressed in relation to Family Provision Act claims in *Schaefer v Schuhmann* [1972] AC 572, Lord Cross speaking for the majority, said at 592:

> "The question whether contracts made by a testator not with a view to excluding the jurisdiction of the court under the Act but in the normal course of arranging his affairs in his lifetime should be liable to be wholly or partially set aside by the court under legislation of this character is a question of social policy upon which different people may reasonably take different view."

Whilst this does not say that a Family Provision claim will overcome a mutual will, it is suggestive of a court being potentially sympathetic to such a claim.

The mutual wills approach also ignores the very many other cross-purchase or buy/sell events such as total and permanent disablement, insanity, bankruptcy, conviction of a criminal offence or unauthorised absence from the business.

It also requires each partner to be the owner of the business or business structure. If a discretionary trust or a spouse holds the shares or units, the mutual wills approach is not available.

Finally, the mutual wills concept creates capital gains tax problems for the survivors. Assuming the business was first commenced after September 19, 1985, the living partner acquires the deceased partner's interest in the business at a cost base equal to that of the deceased. This may be a nominal amount for example, if the deceased person commenced the business by acquiring a $1 share in a shelf company.

On any future sale the whole sale value is capital gains taxable, notwithstanding the fact that, for many years, the continuing owner had contributed to a life insurance policy owned by the deceased, which was to compensate the deceased's estate and dependants.

- In summary, the mutual will approach has the following fundamental uncertainties from a business succession planning perspective:
- A Will can be changed at any time by the testator or testatrix without the consent of the other business owner and without notifying the other business owner. This leads to considerable uncertainty as to the actual transfer of business interest in the event of the death of one of the owners.
- The mutual will approach covers only death as the event leading to the succession of the business, and not sickness, illness, total and permanent disablement, bankruptcy, insanity or the various other events which modern "buy/sell" agreements cater for.
- Applications under the Family Provision Act may frustrate the smooth and efficient transition of ownership of the business.
- If the Will has been changed without the consent of the other business owner, the Executor will be faced with two competing claims (ie the Will beneficiary and the other business owner) both of which appear to have good grounds. Again the smooth transition of the business is frustrated.

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- Potentially high CGT exposures can exist for continuing business owners who inherit business interests with a low cost base.

Conditional Contract

A conditional contract of purchase is simply a fully drafted contract to purchase that is conditional upon an event e.g. proprietor's death. A poorly-drafted conditional contract will attract stamp duty ad valorem based upon the total value of the business.

Avoiding the stamp duty issue by not lodging the document for stamping is no answer at all. Stamp duty in Australia varies in each State and Territory, but a sufficient number of court cases exist to say that an unstamped document is at law totally ineffectual. You may as well not produce the contract at all.

A conditional contract may give rise to a capital gains tax liability when it is signed. Divisions 104 to 109 of the Tax Act broadly state that the capital gains tax event occurs, unless otherwise indicated, at the time of the making of the contract.

A conditional contract supporting a buy\sell arrangement may crystallise capital gains tax many years, indeed decades, before the actual transfer has occurred.

Exchange of Options

The use of put options and call options is generally recognised as the most efficient means of structuring a buy/sell agreement. The use of this approach has the following advantages.

- The adverse capital gains tax implications arising by application of Div 104; Div 109 of the Tax Act should not arise. Of course, capital gains tax may arise at the time that the actual business interests are transferred under the buy/sell agreement.

- There is considerable flexibility provided to both business partners and their estate beneficiaries by having both put options and call options granted.

- The buy/sell agreement should not be void because of a breach of any provisions in the Life Insurance Act.

Share Buy Backs

The use of a share buy back as part of a business succession plan involves considerations under the Corporations Act and the tax laws. Broadly, under this arrangement a company redeems the shares held by a shareholder consequent upon the death or disablement (or some other trigger event) occurring with respect to that shareholder.

Under this approach the source of funds for the payment to the outgoing shareholder comes from the company. Thought must then be given as to where the company will obtain its source of funds in order to effect the share buy back.

The following issues must be considered with respect to share buy back arrangements:

- The Corporations Act requirements must be complied with, including overcoming the restriction on a company financing the acquisition of its own shares.

- The tax implications of an off market share buy back are governed by the Tax Act. Broadly, the Tax Act provides that that part of the purchase price which exceeds the sum of the paid up value of the share and the amount of the purchase price that was debited against the share premium account of the company is treated as a dividend to the shareholder and taxed to the shareholder on that basis. This could offer significant disadvantages to shareholders even if the dividend is fully franked. That is, shareholders who would otherwise be disposing of a share and be subject to the capital gains tax provisions will now be

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taxed on the basis that they have received a dividend. This means that they lose the benefit of any CGT concessions. These disadvantages may be outweighed if the dividend is a fully franked dividend, depending of course on the particular circumstances of the shareholder. More importantly, shareholders who acquired their shares prior to 20 September 1985 will, by adopting the share buy back approach to a business succession plan, be converting what would otherwise have been a tax free capital gain arising as a result of a transfer of their shares to the other business owner to a taxable dividend receipt.

THE CROSS PURCHASE AGREEMENT?

The prime purpose for a cross purchase or buy/sell agreement is to ensure the efficient withdrawal of a partner from a business (or from jointly held property) without the need for expensive legal advice or proceedings. Put simply, it makes good business sense.

Following the death of a partner two needs immediately arise;

- the continuing partners need to take quick control at a reasonable price to protect the ongoing business, and

- the dependants of the deceased need protection from the concerns of the business and the ability to receive full value for the business interests.

A cross purchase agreement meets these needs. All too often we devote our efforts to wealth creation, wealth preservation and wealth distribution (tax effectively) but ignore wealth succession. And yet often the cost of control of wealth succession is very small.

A cross purchase agreement provides control and is designed to protect the value of the business if a partner dies. It provides some guarantee that the estate and dependants will obtain full hassle-free value for the share in a business following the death of a principal.

Cross Purchase Over What?

The more common form of cross purchase agreement is expressed to apply over a business jointly owned by various persons. However, there is no reason why a cross purchase agreement could not also be over property or even exist between two separate and distinct businesses that are reliant upon each other for joint business or raw material.

Death Only?

Death is the most common trigger for a cross purchase agreement but there are others. Total and permanent disablement is also very common, especially because it and death can be covered by life insurance, which is relatively inexpensive in comparison to the value and protections it gives.

There are many other events apart from these two that can trigger the operation of a cross purchase agreement. It is usual however that these other events are very personal to the parties and often require a tailored cross purchase agreement. Examples of these “other events” include bankruptcy, conviction of a crime and retirement.

What Form of Agreement?

It is almost universally accepted by taxation specialists that the best approach is the use of put and call options. The complexities of stamp duty, capital gains tax and income tax support this as being the only real practical approach.

The form of those options should be the right to force another to buy or sell co-existing with each party. This will ensure full protection, the surviving partner can force the estate to sell (call option), or the estate can force the survivors partners to buy (a put option).

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Where Does the Money Come From?

This is up to the business owners and is usually dependent upon the trigger event. As stated earlier, for death or total and permanent disablement, life insurance is the most common source of funding the obligations to buy under the cross purchase agreement. A person can, of course, rely on their own resources (a type of self insurance), although it is usually in the best interests of all if all are required to hold life insurance. This will remove any doubt that one or another party can meet his obligation to purchase.

What Type of Life Insurance?

Again this is up to the business owners, however the decision will be influenced by a number of factors including;

cash flow to support premiums

choice of a policy that has a cash value

views on future changes to the business ownership partnership

Once the business owners have determined the type of policy (and this decision may be different for each partner), the question becomes who should hold that policy. Again, many factors have influence. The simplest arrangement is for a partner to own a policy on the life of each of his other partners. An alternate to this is where a group policy on various lives is held jointly by the partners.

Unfortunately, whilst these approaches seem simple they fail to enable a partner to retain an interest in his policy should he choose to leave the partnership. This can be significant where the policy has a cash value or the partner has for one reason or another become uninsurable or only insurable at a higher premium cost (a loading). Also, real reasons exist as to why a partner may want his policy to be owned by a spouse.

1.1 Practical Insurance Issues

Self ownership of life insurance policies offers the following practical advantages in the “buy/sell” context.

(i) A person who leaves a business without suffering death, total and permanent disablement (“TPD”) or some other event that would trigger the Cross Purchase Option Deed, is able to take a self-owned life insurance policy with them and use it for either personal purposes or, alternatively, to fund in whole or in part obligations under a new cross purchase agreement in respect of a new business that they may become involved in. This is not the case with a cross owned, joint owned or group owned policy.

(ii) Self ownership of life insurance policies is an easy method to administer in practice. For example, in a partnership of five (5) persons, five (5) self-owned insurance policies are needed. Under a cross ownership arrangement twenty (20) life insurance policies are required.

(iii) When a new person enters a business it is a simple procedure to issue them with a life insurance policy over their life. Again, in the cross ownership scenario many more life insurance policies may need to be issued.

1.2 Insurance Taxation Issues

There are also taxation advantages that arise with self ownership of life insurance policies in the “buy/sell” context.

(i) In the circumstances of 1.1(i) above, if a person were to leave a business and the owner of the life insurance policy on that person’s life (eg. the company engaging or employing the person) was to assign that person’s life insurance policy to them, that person would risk being subject to capital gains tax upon the receipt of the life insurance proceeds in accordance with Section 118-300 of the 1997 Income Tax Assessment Act (“the Tax Act”).

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In such circumstances, the person leaving the business is not the original beneficial owner of the policy and, having regard to comments made by the Taxation Commissioner in Exposure Draft Ruling EDR3 (since withdrawn) paragraph 40, it is likely that the Commissioner will take the view (whether that be a legally correct view or not) that, in a commercial environment, the services performed by the person for the business will constitute consideration provided by the person in respect of the assignment of the life insurance policy to them. The provisions in Section 118-300 of the Tax Act would thereby be attracted in the event of the subsequent receipt of the life insurance proceeds by that person.

(ii) Where a new person enters a business, adverse taxation issues may arise in circumstances where the funding for that business's Cross Purchase Option Deed is done by way of group ownership, or joint ownership. In such circumstances, the new person would generally take up an interest in the existing policy. In effect, the existing policy owners each assign a fractional interest in that policy to the new person. The new person is not an original beneficial owner of the policy and, in a commercial environment, it is likely that the Commissioner will take the view that the obligations undertaken by the new person in respect of the Cross Purchase Option Deed in particular and in respect of the business more generally, will constitute consideration given by the new person for the assignment to them of the interests in the policy. Upon receipt of the insurance policy proceeds it is likely that the new person will be subject to capital gains tax in accordance with Section 118-300 of the Tax Act. This disadvantage does not arise in the case of self ownership.

Some buy/sell methods advocate an approach whereby a special purpose insurance trust is the policy owner. Care should be taken under this method to ensure that there are no tax liabilities for the trust beneficiaries upon receipt of the policy proceeds. While a pure life insurance policy may not give rise to a tax liability (see Tax Determination TD 94/31) the position with respect to disability policies or mixed policies is less clear.

CAPITAL GAINS TAX

No discussion of proper succession planning can be concluded without a brief review of some of the capital gains tax concessions available to small and medium business.

Recognising the existence of the 50% exemption benefits in divisions 115 and 152 of the 1997 Tax Act (resulting in a possible exemption of up to 75%) reinforces that proper planning is necessary before adopting any business or investment structure. A myriad of capital gains tax rules need to be properly assessed so as to meet both the immediate and long term future of any business or investment structure.

In certain circumstances a principle capital gains tax concession of 50% is available in respect of a disposal of an asset that has been held for more than 12 months (refer div 115).

That is, the actual tax liability arising from any such capital gain should exceed an effective tax rate of more than 25% (assuming the taxpayer if on the top marginal tax rate). With some proper planning this liability can be reduced even further.

In view of these issues it has become quite popular in recent times for businesses involving more than one person to operate through a partnership of discretionary trusts who appoint a nominee company to conduct the business. Such an approach satisfies the ability to access the 50% goodwill exemption and at the same time provides a simple "face" for the business organisation, the nominee simply acts as an undisclosed representative of the partnership of discretionary trusts.

How will these provisions be impacted by the new business entity tax regime?

What little is available suggests that not only will the 50% goodwill exemption from capital gains tax remain (under a new name) but the principle which suggest that companies and unit trusts are to be avoided will also continue. In other words, more of the same.

The foregoing comments may not be of much comfort to anybody who is currently structured through a unit trust or company. The following analysis may assist.

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Discount Capital Gain and the Discount Percentage

Step 3 of the method statement in section 102-5 requires the taxpayer to reduce the amount of their capital gain (after applying any current year or carried forward capital losses) by any discount percentage that may be applicable to them. As outlined above, in calculating a discount capital gain, section 115-100 provides that a discount percentage of 50% is applied if the gain is made by an individual or a trust, and a discount percentage of 33 1/3% is applied if the gain is made by a complying superannuation entity.

Importantly, the discount capital gain concession applies only where the capital gain results from a CGT event happening to a CGT asset that was acquired by the entity making the capital gain at least 12 months before the CGT event (section 115-25 of the 1997 Tax Act). This requirement, that the asset be held for a period of at least 12 months prior to the CGT event occurring, has given rise to a number of other rules regarding determination of the 12 month holding period. For example, a taxpayer may acquire a CGT asset and, within 12 months of the date of acquisition of the asset, enter into an agreement under which disposal of the asset will take place more than 12 months after the date of acquisition. In these circumstances, section 115-40 of the 1997 Tax Act will apply to prevent the taxpayer from taking advantage of the CGT discount concession. According to the explanatory memorandum to section 115-40... 'This rule will prevent taxpayers inappropriately taking advantage of the CGT discount by seeking to extend artificially the period of ownership of the asset that produces the capital gain.'

The CGT discount also is not available in respect of a capital gain arising from certain CGT events happening to equity interests in a company or a trust if the total of the cost bases of such CGT assets of the company or the trust that were acquired less than 12 months before the CGT event in question is more than one-half of the total of all cost bases of CGT assets of the company or the trust at that time (section 115-45 of the 1997 Tax Act).

Section 115-45 provided as follows:

> **"115-45 Capital Gain from equity in an entity with newly acquired assets**
>
> Your capital gain from a CGT event is *not* a ***discount capital gain*** (despite section 115-5 and subsection 115-30(3)) if:
>
> (a) the CGT event happened to a CGT asset that is:
>
> (i) a share in a company; or
>
> (ii) an interest in a trust; and
>
> (b) the total of the cost bases of CGT assets acquired by the company or trust (as appropriate) *less* than 12 months before the time of the CGT event is more than half of the total of the cost bases of the CGT assets of the company or trust at that time."

Taxation Laws Amendment Bill (No.7) 2000 (now Act No. 173 of 2000), however, repealed these provisions and replaced them with the following:

> **"115-45 Capital gain from equity in an entity with newly acquired assets**
>
> *Purpose of this section*
>
> 1. The purpose of this section is to deny you a *discount capital gain on your *share in a company or interest in a trust if you would *not* have had *discount capital gains on the majority of *CGT assets (by cost and by value) underlying the share or interest if:
>
> (a) you had owned them for the time the company or trust did; and
>
> (b) *CGT events had happened to them when the CGT event happened to your share or interest.

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When a capital gain is not a discount capital gain

2. Your *capital gain from a *CGT event happening to:

(a) your *share in a company; or

(b) your *trust voting interest, unit or other fixed interest in a trust;

is *not a* ***discount capital gain*** if the 3 conditions in subsections (3), (4) and (5) are met. This section has effect despite section 115-5 and subsection 115-30(2).

You had at least 10% of the equity in the entity before the event

(a) Immediately prior to the *CGT event, you and your *associates beneficially owned:

 (i) at least 10% by value of the *shares in the company (except shares that carried a right only to participate in a distribution of profits or capital to a limited extent); or

 (ii) at least 10% of the *trust voting interests, issued units or other fixed interests (as appropriate) in the trust.

Cost bases of new assets are more than 50% of all costs bases of entity's assets

(b) The second condition is that the total of the *costs bases of *CGT assets that the company or trust owned at the time of the *CGT event and had *acquired *less* than 12 months before then is *more* than half of the total of the *cost bases of the *CGT assets the company or trust owned at the time of the event.

Net capital gain on entity's new assets would be more than 50% of net capital gain on all the entity's assets

(c) The third condition is that the amount worked out under subsection (6) is more than half of the amount worked out under subsection (7).

(d) Work out the amount that would be the *net capital gain of the company or trust for the income year if:

 (i) just before the *CGT event, the company or trust had *disposed of all of the *CGT assets that it owned then and had *acquired less than 12 months before the *CGT event; and

 (ii) it had received the market value of those assets for the disposal; and

 (iii) the company or trust did not have any *capital gains or *capital losses from *CGT events other than the disposal; and

 (iv) the company or trust did not have a *net capital loss for an earlier income year.

(e) Work out the amount that would be the *net capital gain of the company or trust for the income year if:

 (i) just before the *CGT event, the company or trust had *disposed of all of the *CGT assets that it owned then; and

 (ii) it had received the market value of those assets for the disposal; and

 (iii) all of the *capital gains and *capital losses from those assets were taken into account in working out the net capital gain, despite any rules providing that one or more of those

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capital gains or losses are not to be taken into account in working out the net capital gain; and

(iv) the company or trust did not have any *capital gains or *capital losses from *CGT events other than the disposal; and

(v) the company or trust did not have a *net capital loss for an earlier income year."

The discount capital gain concession specifically does not apply to some CGT events, generally those that involve the creation of an asset immediately prior to its disposal such as restrictive covenant payments made to former employees. The following table (taken from paragraph 11.28 of the explanatory memorandum) summarise the CGT events that do not qualify for the CGT discount.

"11.28 Table 11.2 sets out those CGT events that do not qualify for the CGT discount:

CGT events that do not qualify for the CGT discount	
D1	Creating contractual or other rights - the CGT event happens upon the creation of the right.
D2	Granting an option - the CGT event happens upon granting, renewal or extension of the option.
D3	Granting a right to mining income - the CGT event happens upon granting the right to mining income.
E9	Creating a trust over future property - the CGT event happens at the time of the agreement to hold future trust property.
F1	Granting a lease - the CGT event happens upon the grant, renewal or extension of the lease by the lessor.
F2	Granting a long-term lease - the CGT events happens upon the grant, renewal of extension of a long-term lease by the lessor.
F5	Lessor receives payment for changing lease - the CGT event happens on the varying or waiver of the terms of the lease.
H2	Receipt for event relating to a CGT asst - the CGT event happens at the time of the act, transaction or event.
K1	Partial realisation of intellectual property right - the CGT event happens on realisation or on entering into a contact for realisation.

In some circumstances, a taxpayer who acquires an asset within 12 months of the CGT event happening will, nonetheless, be eligible for the CGT discount concession. Section 115-30 sets out special rules regarding the time of acquisition of certain assets.

For example, in circumstances where a taxpayer acquires a CGT asset as a replacement asset under a replacement asset rollover provision, or in circumstances giving rise to a same asset rollover, then the collective period of ownership is considered. That is, where a same asset rollover has taken place, then the acquisition date for the current owner will be considered as the acquisition date that applied to the entity that previously owned the asset. Where a replacement asset rollover is acquired, the relevant acquisition date will be the date that the replaced asset was acquired by the taxpayer.

For deceased estates, the acquisition date of an asset for an executor and estate beneficiary is taken to be the date that the deceased acquired the asset. Under the scrip for scrip capital gains tax concession, the acquisition date of the replacement interests is deemed to be the acquisition date of the original interests.

Small Business Relief

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Step 4 of the method statement in section 102-5 requires the taxpayer to apply against each of their capital gains any concessions that may be available in subdivisions 152-C, 152-D and 152-E of the 1997 Tax Act.

Division 152 of the 1997 Tax Act contains all of the provisions previously dealing with small business rollover concessions, including the active assets concession, the 15 year holding exemption, the replacement asset concession and the retirement rollover concession.

Introduced in subdivision 152-B is an exemption from the capital gains tax regime where a small business entity disposes of a CGT asset that it has owned for at least 15 years, provided that certain conditions are met.

The 50% goodwill exemption that existed under the 1936 Tax Act for disposals of a business that included the disposal of goodwill has been replaced with what may be called a 50% active asset concession, the provisions for which are found in subdivision 152-A and 152-C.

The small business relief provisions in Division 152 are very specific in their application, and business entities will either fall within or outside some or all of the concessions depending upon the particular business structure that exists.

In seeking to apply any of the small business relief concessions to trusts, particular regard will need to be had to the nature of the trust, entitlements under the trust, and whether the particular trust forms part of a larger business structure. That is, the small business relief provisions apply differently depending on whether the trust itself is the business entity or whether a company or unit trust is the active business entity with a discretionary trust or trusts being the shareholders or unitholders. The small business relief provisions also apply different again if individuals rather than discretionary trusts are the shareholders or unitholders in the active business entity.

In short, in determining whether any of the small business relief concessions are available it is necessary to understand all aspects of the business structure and work through the provisions in Division 152 in a methodical and meticulous manner.

All of the small business relief concessions are subject to the basic conditions as set out in subdivision 152-A. The basic conditions as set out in section 152-10(1) and (2) are as follows:

> "**152-10 Basic conditions for relief**
>
> (f) A capital gain you make may be reduced or disregarded under this Division if the following basic conditions are satisfied for the gain:
>
> i. a CGT event happens in relation to a CGT asset of yours in an income year;
> ii. the event would (apart from this Division) have resulted in the gain;
> iii. you satisfy the maximum net asset value test (see section 152-15);
> iv. the CGT asset satisfies the active asset test (see section 152-35).
>
> (g) If the CGT asset is a share in a company or an interest in a trust, there are 2 additional basic conditions:
>
> i. the company or trust satisfies the controlling individual test (see section 152-50);
> ii. you are a CGT concession stakeholder in the company or trust."

The maximum net asset value test as referred to in section 152-10(1)(c) is set out in section 152-15 as follows:

> "**152-15 Maximum net asset value test**
>
> (h) You satisfy the maximum net asset value test if, just before the CGT event:
>
> i. the sum of the following amounts does not exceed $5,000,000:
>   1. the net value of the CGT assets of yours;
>   2. the net value of the CGT assets of any entities connected with you;
>   3. the net value of the CGT assets of any small business CGT affiliates of yours or entities connected with your small business CGT affiliates; and

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Note: Some assets aren't included in the definition of ***net value of the CGT assets***: see subsections 152-20(2) and (3).

ii. if you are a partner in a partnership and the CGT event happens in relation to a CGT asset of the partnership - the net value of the CGT assets of the partnership does not exceed $5,000,000."

Terms such as 'net value of the CGT assets', 'small business CGT affiliate' and 'connected with' are set out in sections 152-20, 152-25 and 152-30 respectively.

The active asset test as referred to in section 152-10(1)(d) is defined in section 152-35. The term 'active asset' is defined in section 152-40.

The 'controlling individual test' as referred to in section 152-10(2)(a) is defined in sections 152-50 and 152-55. The expression 'CGT concession stakeholder' as used in section 152-10(2)(b) is defined in section 155-60. Both sections 152-55 and section 152-60 are premised on an individual being the controlling individual of an entity (company or trust) where the CGT asset in question is shares in the company or interests in the trust. Sections 152-55(2) and (3) set out the tests for determining whether an individual is a controlling individual of a trust.

Where a company or trust is an active business entity, and the entity disposes of an active asset (that is a CGT asset but is not a share in a company or an interest in a trust) that would give rise to a capital gain, then the basic conditions for relief will be satisfied provided of course that the maximum net asset value test is satisfied.

Where the asset being disposed of is a share in a company, a unit in a unit trust or an interest in a trust then the additional tests in section 152-10(2) (being the "controlling individual test" and the "CGT concession stakeholder test") must also be satisfied. In order for the small business relief to apply in these circumstances, there will need to be a controlling individual of the entity in respect of which the share, unit or interest is being disposed of and the person making the capital gain must be a "CGT concession stakeholder" ie either the controlling individual or a spouse of that controlling individual.

The provisions defining a "controlling individual" and a "CGT concession stakeholder" are set out below:

"152-55 Meaning of controlling individual

Companies

(i) An individual is a ***controlling individual*** of a company at a time if, at that time, the individual holds the legal and equitable interests in shares, other than redeemable shares, that carry (between them) the right to exercise at least 50% of the voting power in the company and receive at least 50% of any dividend the company may pay and of any distribution of capital the company may make.

Trusts

(j) An individual is a ***controlling individual*** of a trust (where entities have entitlements to all the income and capital of the trust) at a time if, at that time, the individual is beneficially entitled to at least 50% of the income and capital of the trust.

(k) An individual is a ***controlling individual*** of a trust (where entities do not have entitlements to all the income and capital of the trust) at a time if, during the income year in which the time occurs:

i. the trust made a distribution of income or capital or both; and

ii. the individual was beneficially entitled to at least 50% of the total of the distributions of income made by the trust during the income year; and

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iii. the individual was beneficially entitled to at least 50% of the total of the distributions of capital made by the trust during the income year.

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152-60 Meaning of CGT concession stakeholder

(l) **CGT concession stakeholder** of a company or trust means:

i. a controlling individual of the company or trust; or
ii. in the case of a company - a spouse of a controlling individual of the company, if the spouse holds the legal and equitable interests in any amount of shares in the company; or
iii. in the case of a trust mentioned in subsection 152-55(2) - a spouse of a controlling individual of the trust, if the spouse is beneficially entitled to any of the income or capital of the trust; or
iv. in the case of a trust mentioned in subsection 152-55(3) - a spouse of a controlling individual of the trust if, during the income year referred to in that subsection, the trust made a distribution of income or capital to which the spouse was beneficially entitled."

In general terms, it would appear that a disposal of shares in a company or units in a unit trust will not give rise to the small business relief concession in circumstances where, for example, more than 50% of the share or units are held by discretionary trusts or by individuals who were not the individuals who disposed of their shares or units. Also, the small business relief would likely not be available to disposals of interests in discretionary trusts or hybrid styles of trusts in circumstances where either:

(a) no distributions of income or capital were made by the trustee during the year in which the CGT event occurred;

(b) any such distributions were made by the trustee to entities that are not individuals; or

(c) distributions of more than 50% of income or 50% of capital were made to individuals who were not either the individual who disposed of the CGT interest or the spouse of that individual.

In applying the small business 15 year exemption under sub-division 152-B another condition that must be satisfied is that, if the entity making the disposal is a trust, the entity must have had a controlling individual throughout the period of ownership of the asset and the individual who was the controlling individual just before the CGT event occurred must retire or be permanently incapacitated.

With respect to the small business retirement exemption in sub-division 152-D it is also important to note that specific conditions exist in section 152-325 dealing with companies or trusts that receive capital proceeds from the occurrence of a CGT event and who wish to make a choice under that sub-division to apply the small business retirement exemption.

CONCLUSIONS

It is hoped that the foregoing has given you a bit of an indication as to how you can start the process of proper business succession planning.

The only word of advice that can be given to you is to start. How long will it take is entirely up to you.

What is necessary and what will be involved again is entirely up to you.

Just remember,

Failing to plan

is planning to fail

Good luck!

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