THE TAXATION IMPLICATIONS OF INSURANCE IN BUSINESS SUCCESSION PLANNING IN AN AUSTRALIAN CONTEXT—A PROPOSAL FOR REFORM

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ABSTRACT

There are approximately 2 million small businesses in Australia. Many such businesses operate with more than one owner[1] who together may manage the small business.[2] An owner may die or suffer from a disability and be unable to continue to work in the business. The other owners may not want the 'outgoing' owner's family to be involved in the ownership and ongoing management of the business.

To deal with these possibilities, the owners can agree together what will happen if one of the owners dies or is disabled.[3] Such a succession plan can require the other owners to purchase and the 'outgoing' owner to sell his or her business interest when the death or disability occurs. When an owner becomes so incapacitated, a question arises how the other owners can fund the purchase. Obtaining funds to purchase the outgoing owner's interest in the business may be difficult, especially if the death or disability was unforseen. While some owners may have sufficient moneys to fund the purchase others may wish to take out life and other insurances.

This thesis comments on the challenges facing a small business in developing such an insurance-funded succession plan, particularly concerning taxation consequences that can arise in these circumstances. There is taxation legislation that affects the purchase, transfer and proceeds of the insurance. However, the research contends that the legislation and its implementation through the Australian Taxation Office (ATO) are imperfect and ambiguous. This is based on the benchmarks of efficiency, simplicity and fairness as developed from the Meade (UK) and Asprey (Australian) reports for best practice in taxation. Based on the benchmarks the taxation legislation fails these tests. In particular, the insurance premiums, used to fund the outgoing principal's interest in the business, are often not deductible and yet the proceeds may be taxed. Transfers of

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[1] The definition of 'small business' is set out in Chapter One of the research. As to the number of small businesses, see the Australian Bureau of Statistics, *Counts of Australian Businesses, including Entries and Exits, June 2007 to June 2009* 8165.0 (31 January 2012). As to the number of owners in a small business, see the Australian Bureau of Statistics, *Characteristics of Small Business, Australia (Re-issue)* 8127.0 (29 April 2005).

[2] In June 2006, 67 per cent of all small business operators worked full-time hours (defined as working 35 hours or more per week), while 33 per cent of all small business operators worked part-time hours (less than 35 hours per week). Australian Bureau of Statistics, *Australian Small Business Operators—Findings from the 2005 and 2006 Characteristics of Small Business Surveys, 2005–06* 8127.0 (6 August 2008).

[3] This term is defined in Chapter One.

insurance policies are taxed[4] and the other owners may receive a reduced cost base, for capital gains tax purposes, upon acquiring the outgoing owner's interest.[5]

The ATO acknowledged problems with the taxation legislation in its discussion paper on business succession planning published in 2000. Many commentators relied on the discussion paper however, it was never finalised beyond a discussion paper and withdrawn without reason in 2010.

Other jurisdictions have adapted their taxation systems to accommodate the needs of insurance funded business succession planning. The research compares the Australian system with that existing in the US. The US is chosen because it one of the first countries to consider succession planning, has the greatest amount of literature and a certain and fair taxation treatment of the succession planning insurance. The comparison supports the conclusions regarding the need for change to Australian legislation to achieve best taxation practice.

Suggested reforms seek to alleviate inconsistencies and deficiencies in the current taxation system to ensure greater certainty and fairness and thus a greater incentive for small business owners to enter into succession planning agreements. These suggested reforms to the legislation, as they relate to a succession plan, include:[6]

1. Clear and unambiguous legislation that the 'outgoing' owner's interest is disposed of when he or she dies or suffers from the disability, rather than when the succession plan is entered into.

2. The generous concessions provided to life insurance be extended to other forms of insurance used in the succession plan.

3. The insurance used for succession planning be deductible as to the premiums, and the proceeds be free of income tax, including CGT.

4. Clear and unambiguous legislation stating that succession planning insurance is an acceptable investment for superannuation.

[4] For example, a principal may retire and want to take the insurance policies. This is relevant if an owner enters or leaves the business outside the operation of the succession plan.
[5] Capital gains tax (CGT) is considered in Chapter Five.
[6] For a justification for the perceived 'double dipping', with the insurance proceeds then being used to establish the first element of the cost base, see Chapter Seven.

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LIST OF ABBREVIATIONS

APRA	Australian Prudential Regulation Authority
ATO	Australian Taxation Office
CGT	capital gains tax
GST	Goods and Services Tax
ID	Interpretive Decision
NSW	New South Wales
PBR	Private Binding Ruling
SIS	*Superannuation Industry (Supervision) Act 1993*
SMSF	self-managed superannuation fund
SMSFD	Self-Managed Super Fund Determination
TD	Tax Determination
TPD	Total and Permanent Disability

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CHAPTER ONE: INTRODUCTION

> ‘The widow stood at the graveside as the coffin was slowly lowered. She looked across at her late husband’s business partner. “I’ll make him pay double if he wants my husband’s half of the business,” she thought.
>
> The business partner caught the widow’s mournful eye. ‘I’ll offer her one tenth. She would not know what it is worth. Anyway, without me it is worth nothing.’[1]

A. Overview

This research presents a systematic, historical and legal study of the taxation of insurance in business succession planning (succession planning).[2] Succession planning, for the research’s purposes, is an agreement between the owners of a business where if a principal dies or is disabled, the remaining owners will purchase the deceased’s business interest at an agreed price.[3] The insurance proceeds provide the purchase price. The insurances used are life, Total and Permanent Disability (TPD) and trauma (collectively ‘insurance’). The terms ‘disability’ and ‘disabled’ refer to a principal who suffers either TPD or trauma and, for that reason, is no longer able to work in the business.[4]

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[1] Peter Bobbin, *Successful Succession for Success* (Taxation Institute of Australia, 13th National Tax Intensive Retreat, 26 August 2004 and 2 December 2005) 3.

[2] Succession planning is known by other expressions. For example, see George J Laikin and LR Lichter, ‘Tax Aspects of Survivor-Purchase Agreements’ [1948] *Wisconsin Law Review* 139, who use the expression ‘survivor-purchase agreement’. In other jurisdictions, notably the UK, the term ‘business succession planning’ is more restrictive and typically refers to the passing of a family-owned business from one generation to the next following the death or disability of an owner. See Clydesdale Bank, ‘Business Guide: Business Succession Planning’ (2005) <http://www.cbonline.co.uk/0,,70740,00.html> 2. In that context, the phrase commonly applies to the disposition of a sole proprietor’s business interests with a Will or *inter vivos* disposition. In other jurisdictions—for instance, the US and Canada—what is known in Australia as succession planning is better known as a ‘buy-sell agreement’. See AR Fantini, RA Esperti and RL Peterson, *Love, Money, Control: Reinventing Estate Planning* (Esperti Peterson Institute, 2004) 383. Some Australian commentators use the expression ‘business succession planning’ more generally to include any change of the principals or ownership of a business, and reserve the term ‘buy-sell agreements’ for small businesses that fund their plans using insurance, see Bernie O’Sullivan, *Estate & Business Succession Planning 2011–12* (Taxation Institute of Australia) 330.

[3] For the purposes of the research, the agreed price, fair market value and value of the insurance proceeds are assumed to be the same amount.

[4] As set out in that part of this chapter dealing with scope, it is possible for the principal to suffer a trauma event, such as a minor heart attack or stroke, and be able to continue working in the small business in the same capacity. While these situations need to be addressed in the succession plan, this research does not deal with these circumstances.

The study considers whether, and if necessary how, the taxation of such insurance should be reformed in a succession planning context. Recommendations are based on the taxation benchmarks set out in this chapter.

B. Scope

The research examines the taxation of insurance as a funding mechanism in a succession plan for small businesses. This includes the purchase, transfer and payout of the insurance and creating the succession planning agreement. Based on the taxation benchmarks established in this chapter, taxation deficiencies are highlighted and reforms suggested. Except to highlight Commonwealth taxation issues surrounding, primarily, CGT issues, the research does not consider State and Territorial taxes, such as stamp duty or transfer duty. Fringe benefits tax[5] and the Goods and Services Tax (GST) are also not considered in any detail.[6]

Any suggested reforms are intended for the Australian Government and Australian commentators. Accordingly, consideration of non-Australian law and court decisions is for illustrative and comparative purposes only. Where a comparative study is appropriate, it is primarily based on the US where, as established in Chapter Three, the law is more certain and contains the greatest volume of literature.[7]

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[5] Fringe benefits tax has little specific application to insurance policies owned under a succession plan. Where insurance policies are classed as a capital expense, they are not generally deductible under *ITAA 1997* s 8-1. If the company, as employer, were to pay the premiums on behalf of an owner or principal as employees, it may be deductible to the employer as a business expense. However, the benefit may be lost by the application of the fringe benefits tax; although this only applies where the payment was directly attributable to the owner or principal acting in the capacity of employee. See, generally, *Fringe Benefits Tax Assessment Act 1986* (Cth). In the more common case, where the payment is a 'drawing' or use of profits by the principal, the fringe benefits tax will not apply. However, the owners and principals of the business may also be employees. They could enter into salary packaging arrangements with the business as their employer for the payment of succession planning insurance. In this case, they ask their employer to pay the insurance premiums on their behalf from pre-tax salary. However, subject to the nature and purpose of the insurance policy, there are generally fringe benefits tax implications with these types of salary packaging arrangements and this approach is not further considered in this research.

[6] The goods and services tax (GST) took effect from 1 July 2000. It is predominantly administered under the *A New Tax System (Goods and Services Tax) Act 1999* and *A New Tax System (Goods and Services Tax Administration) Act 1999*. Effects of the GST on succession planning beyond the insurance considerations are varied. As an illustration, the purchase of insurance policies from an insurance provider will necessarily incur a component of GST. As to the complexity in this area, see Matthew Burgess, 'Estate Asset & Business Succession Planning' (Taxation Institute of Australia Business Succession Planning Forum, Brisbane, 2005) 12 in which Burgess sets out the GST issues surrounding insurance policies in succession planning.

[7] There are innumerable taxation models across the globe that touch on and affect succession planning. It is of limited value to make comparisons between Australia's taxation treatment of succession planning

The research does not consider how or by what criteria a business is valued.[8] It also does not consider a succession plan that is not fully funded by the insurance.[9] The research does not test whether other forms of finance are available or are superior to insurance. Non-insurable events (such as bankruptcy and retirement; a summary of which is set out in Chapter Three), while having their own taxation issues, are outside the scope of the research. As to succession planning, O'Sullivan stated that 'we are not focusing on the transfer of equity when a person reaches normal retirement age or there is a planned trade sale, listing or management buy-out'.[10] This research adopts this approach and limits the events to the insurable events; being the principal's death or disability where it is funded by insurance.

Not all CGT effects and issues are considered. Pre-CGT assets that come within CGT event K6 and *ITAA 1997* Division 149 are not discussed in detail.[11] Similarly, the 50 per cent CGT discount for individuals and trusts under *ITAA 1997* Division 115 and the Small Business concessions under *ITAA 1997* Division 152 are not considered.[12]

The research only considers succession planning for a 'small business'.[13] 'Small business'[14] is defined by reference to the term 'small business operator'.[15] This is as the

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and those of vastly different economic and taxation frameworks. Likewise, comparisons with countries that are similar only allow limited reflection. See for example, Mark Peart, 'Quitting a Business is Easier Said than Done' (2006) 2 *The National Business Review (NZ)*. It would be more constructive to compare the Australian case with the practices of a country that embraces succession planning and that also has a political and legislative system that operates in much the same fashion as in Australia, but with enough critical differences as to allow genuine contrast. For the purposes of this research, the systems used in the Unided States (US) are examined. Further, the US has a wealth of available literature on the topic and often plays a direct role in Australia's policy development. It is probable, given the early dates of some literature that deals with succession planning in the US (and the progressive nature of business and commercial issues there), that many of the trends in succession planning here in Australia can be traced to earlier developments in the US. Due to its economic influence, the US is often emulated in other jurisdictions *inter alia* in commercial issues, such as in succession planning. The US has a highly developed succession planning set of rules, as examined in Chapter Three. It also has the largest amount of articles written on the subject. The US system is therefore employed to provide context to the Australian system.

[8] For example, the business could be valued based on a 'fair market value'.

[9] Issues can arise if a succession plan is not fully funded. These issues include where the funds are to be derived to pay the purchase price and how and over what period they are to be paid.

[10] O'Sullivan, above n 2, 348.

[11] For an excellent overview of the effects of CGT event K6 and div 149 *ITAA 1997*, see Peter Bobbin, *Successful Succession for Success* (Taxation Institute of Australia, 13th National Tax Intensive Retreat, 26 August 2004 and 2 December 2005) 17.

[12] As to these CGT concessions as they relate to succession planning, see Bobbin, above n 11, 14.

[13] Neither the *ITAA 1936* nor the *ITAA 1997* define 'small business'. However, *ITAA 1936* s 128TK provides that the interchangeable expressions 'SME' and 'small-medium enterprise' mean a company whose assets' total value is no more than $50 million. Further, the concept of a small business CGT affiliate was relevant to the definition of entities connected with the taxpayer under the former *ITAA 1997* s 123-60, the $5 million test under former the *ITAA 1997* s 123-50 and the definition of 'active asset' in the former *ITAA 1997* s 128-80. In addition, *ITAA 1997* s 328-110, dealing with concessions that are

expression is used by the Australian Bureau of Statistics.[16] This is 'a business with less than 20 employees', excluding agricultural businesses. The scope of the research is further reduced by adopting this definition with two further qualifications:

1 **Sole proprietor businesses** are excluded because they have their own unique succession planning needs and succession planning is traditionally 'where a business has more than one equity holder'.[17] Sole proprietors have no co-owners with which to enter into a succession plan.[18] A succession plan could be

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available to small business entities, states that a business entity is a small business entity if the aggregated turnover for the year is less than $75,000. S 328-110 defines the term 'small business entity' as:

> You are a small business entity for an income year (the current year) if:
> a. you carry on a business in the current year; and
> b. one or both of the following applies:
> i. you carried on a business in the income year (the previous year) before the current year and your aggregated turnover for the previous year was less than $2 million;
> ii. your aggregated turnover for the current year is likely to be less than $2 million (s 328-110(1)).

[14] There is no general tax definition of a 'small business'. There are numerous cases on the definition of a 'business'. However, these are unhelpful for the purposes of this research. See for example, a 'business' is a commercial enterprise in the nature of a going concern, and are activities engaged in for the purpose of profit on a continuous and repetitive basis: *Hope v Bathurst City Council* (1980) 144 CLR 1, 3. For taxation purposes, a 'business' includes any profession, trade, employment, vocation or calling, but not occupation as an employee: for example, *ITAA 1997* s 995-1. Whether a particular activity constitutes a business for taxation purposes is a question of fact and degree and no one factor is decisive in determining whether a business exists: *Evans v FCT* (1989) 20 ATR 922. However, the courts have identified a number of characteristics that indicate the existence of a business, such as profit-making, repetition, regularity, organisation and the use of a system: *Ferguson v FCT* (1979) 26 ALR 307. The concept of 'small business' is considered under the Small Business Fair Dismissal Code as an enterprise that has no more than 15 employees employed on a full-time equivalent basis: *Fair Work Act 2009* s 388(1).

[15] Australian Bureau of Statistics, *Australian Small Business Operators—Findings from the 2005 and 2006 Characteristics of Small Business Surveys, 2005–06* 8127.0 (6 August 2008).

[16] The Council of Small Business of Australia also uses this definition. Council of Small Business of Australia, *How to Define a Small Business?* < http://www.cosboa.org.au/Post/Howtodefineasmallbusinesswellfirstlyweareallpeople>.

[17] In a 'sole proprietor business', there are no other co-owners with which to enter into a succession plan. Brett K Davies et al., *Australian Financial Planning Handbook* (2010 ed, Thomson Reuters) 815; see also Leigh Riley, *Developing a Sole Proprietor Succession Plan* (2009) <http://mybrc.com.au/Money-Legal/Managing-Money/Succession-Planning/Pages/Developing_Sole_Proprietor_Succession_Plan.aspx>; Miranda Stewart, 'Business Succession: ATO Issues More Guidance on Buy-Sell Agreements and Insurance' (2010) 45 *Taxation in Australia* 4, 195. The business succession needs of the sole proprietor were identified as early as the 1950s, see SM Fahr, 'The Business Purchase Agreement and Life Insurance' (1950) 15 *Law and Contemporary Problems*, 319, 326:

> In the case of the sole proprietorship, the buy and sell agreement is likely to be between the owner and one or more of his employees, since generally they will be the only persons capable of taking over his business and making a success of it. … One immediate choice would be the trusty employee who stands certain to take over.

[18] Life, TPD and trauma insurance can still be useful, especially when the sole proprietor has entered into a succession plan with employees. In that instance, it is open for the sole proprietor and employees to share the cost of the insurance. Further, competitors can enter into a succession plan and use insurance to fund the outgoing sole proprietor's interest if the sole proprietor dies or is disabled.

considered with the sole proprietor's employees and competitors. However, this is outside the scope of the research.[19]

2 **Family-owned businesses** are excluded 'because the owners of such enterprises often view them as family assets, perhaps more like family "heirlooms"'.[20] They have their own unique succession planning requirements such as being more likely to act not at arm's length.[21] Dr Anthony Fantini stated that 'for parents, gift giving is the simplest, most frequently used, and often the most powerful method of transferring the business to children and other family members'.[22] Conversely, for succession planning for non-family businesses, the objective is removing the dead or disabled principal's family from the business as quickly as possible.[23] While it is still open for families to have disputes 'with a savagery that makes most business battles look like petty squabbles',[24] there are a number of cases in which family members have been removed from the business.[25] There are also long-term deadlocks over different directions of the family business.[26] However, succession planning is generally between 'unrelated parties'.[27] Accordingly, family-owned businesses are not considered in this research.[28]

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[19] Michael Sayer, 'Business Succession for Sole Proprietors', *The Corporate Will Company* (August 2009) <http://www.cwcpharmacy.com.au/userfiles/file/19_business%20succession%20for%20sole%20proprietors%20article.pdf>.

[20] Howard M Zaritsky, *Structuring Buy-Sell Agreements* (Warren, Gorham & Lamont, 2nd ed, 2000) 1.02[1]. For an explanation on the needs of family succession planning, see Fantini, Esperti and Peterson, above n 2, 380.

[21] For example, a family-owned business may be prepared to gift their interest in the business to a family member for no consideration, other than perhaps 'love and affection'. See FG Corneel, 'Dealing with Conflicts in Family Corporations' (1981) 15 *University of Miami Estate Planning Institute*, ch 18.

[22] Fantini, Esperti and Peterson, above n 2, 397.

[23] See HM Zaritsky and SR Leimberg, *Tax Planning with Life Insurance* (Warren Gorham Lamont, 1992) 7–25, in which the authors state that a succession plan 'prevents the sale ... outside the present ownership group ... and it is often the paramount reason for using buy-sell agreements'.

[24] Zaritsky, above n 20.

[25] In *Re HR Harmer Ltd* (1959) 3 All ER 689, two sons sought judicial removal of their 80-year-old father and founder of the family stamp business due to alleged oppressive behaviour. See also *Glazer v Glazer* (1966) 374 F2d 390 (5th Cir), in which two brothers, while serving in World War II, challenged the actions of the third brother who continued to run the business.

[26] See, for example, *Jackson v Nicolai-Neppach Co* (1959) 29 Or 560, 348 P2d; *Re Radom & Neidorff* (1954) 307 NY 1, 119 NE2d 563; *Gidwitz v Lanzit Corrugated Box Co* (1960) 20n 20 Ill 2d 208, 170 NE2d 131; Comment (1961) 74 *Harvard Law Review* 1461.

[27] O'Sullivan, above n 2, 335.

[28] The insurances would be of potential use. For example, if there were two children, then it is open for the family-owned business to be gifted to the child working in the business, with insurance equal to the value of the business going to the other child. This is colloquially referred to as 'insurance equalisation',

'Small business'[29] or 'business' is therefore defined as an enterprise with less than 20 employees excluding enterprises that are agricultural, sole proprietorships or family owned. There are approximately 2 million small businesses fitting this criterion in Australia.[30]

C. Research Aims

This thesis considers whether insurance-funded succession planning is important and, based on the taxation benchmarks, is unduly hindered by the current taxation regime. If it is so hindered then reforms are suggested. The aim of the research is to test the following statements, being whether:

1. small businesses are important to the economy;
2. death or disability of a principal can risk the existence of an otherwise viable business;
3. viable small businesses should be encouraged to continue to operate after a principal's death or disability;
4. both succession planning and insurance as a funding mechanism help a business to continue to operate after the death or disability;
5. the taxation system, based on the taxation benchmarks, hinders the insurance-funded succession planning process; and
6. the suggested taxation reform will help provide for a better and more certain taxation outcome based on the taxation benchmarks and thus remove a barrier for owners wishing to enter into a succession planning agreement.

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as discussed by Super Dynamics Pty Ltd (2010) <http://www.superdynamics.com.au/estate-equalisation.html>.

[29] For the purposes of this research, the structure with which the business operates is not relevant. Common structures may include a proprietary limited company (in which the owners hold shares); partnerships (made up of humans or non-humans, in which the owners hold a percentage interest each in the partnership); a subset of a partnership, being a partnership of family trusts (in which the trustee of each family trust owns a percentage of the partnership); hybrid trusts; and unit trusts.

[30] These are the most up-to-date statistic available. Australian Bureau of Statistics, *Counts of Australian Businesses, including Entries and Exits, June 2007 to June 2009* 8165.0 (31 January 2012).

To support the pursuit of these aims, the research discusses the taxation benchmarks. In Chapter Two, the value of succession planning to the business owners, employees and the economy is considered. The importance of using insurance to provide certainty is established. An historical review of the insurances and of succession planning sets the foundation on which to consider taxation issues against the taxation benchmarks.

From these foundations, the research considers any taxation deficiencies and inequities present for succession planning in Australia. Where it is useful to do so, such deficiencies and inequities are contrasted with other jurisdictions, particularly the US.[31] As to any identified deficiencies in the taxation system, the research suggests reforms to the relevant parts of the Australian taxation system.

D. Significance and Contribution of the Research

This research comments on how succession planning using insurance as a funding mechanism is taxed in Australia. Some studies referred to in the research produce important findings. However, there is no conceptual framework employed to construct and conduct the studies and interpret the findings. The current literature is comprised of single papers that examine narrow approaches to succession planning, often from the perspective of a particular law firm or insurance company. The current literature rarely challenges or considers alternatives to statements issued by the taxation regulator, the Australian Taxation Office (ATO). Moreover, these papers do not provide a comparative study with overseas jurisdictions. These papers are mentioned, primarily, in Chapter Three. Unlike these papers, this research develops and uses the taxation benchmarks to judge the merits of the current taxation system in Australia.

There is no Australian historical consideration of succession planning in the papers, such as is undertaken in Chapter Three. The historical development of succession planning also considers the development of succession planning from an international perspective, to provide context to the Australian model. Further, the historical development of insurance used in succession planning, also given in Chapter Three, sets out definition issues. The research highlights the difficulty the

[31] The US was chosen for the reasons as set out in Chapter One.

ATO faces in interpreting the legislation and policy and the tax treatment that results from that difficulty.

Taxation laws are often portrayed as external factors outside the control of a small business.[32] In contrast, larger businesses may have greater resources to 'invest heavily in external affairs and direct lobbying to secure changes in the law to suit their purposes'.[33] Small numbers of large businesses can more easily form a persuasive lobby group to challenge perceived unfair tax laws. Succession planning, in the context of this research, relates to small businesses. Small businesses may be less likely to have the resources to consider the taxation system for potential reform. The research contributes to the body of knowledge by suggesting reforms in this area based on the taxation benchmarks that are now developed.

E. The Taxation Benchmarks

The research considers how the taxation system treats insurance as a funding mechanism in succession planning. It then asks if the taxation treatment is appropriate against the taxation benchmarks.[34] Where the current system is deemed not appropriate, reforms and improvements are suggested. As Professor Dale Pinto has stated, 'it is important to identify some guidelines or criteria which can be used to judge the performance of a tax system, as well as any proposed reforms'.[35] This section of the chapter establishes the taxation benchmarks.

Adam Smith set out three core principles of a taxation system:[36] simplicity, equity and efficiency.[37] As Alley and Bentley stated:[38]

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[32] Rolffe Peacock, 'Failure and Assistance of Small Firms' *Understanding Small Business* (Submission relating to Bureau of Industry Economics, 2000) 7.

[33] Emer Mulligan, *Tax Planning in Practice: A Field Study of US Multinational Corporations* (PhD Research, Warwick Business School, University of Warwick, March 2008) XI.

[34] Numerous articles consider what constitutes a good tax system. For example, Michael Dirkis and Brett Bondfield, 'Ahead of "Two Days in October": Reviewing the Status of the Recommendations of Australia's Future Tax System Review' (2011) 26 *Australian Tax Forum* 3, 432 and Evatt Foundation Group, 'A Fair and Adequate Tax System: Some Observations by the Evatt Foundation Group' (1999).

[35] Robin Woellner et al., *Australian Taxation Law* (CCH Australia Ltd, 21st ed, 2011), 22.

[36] This is as interpreted by Kathryn Sutherland (ed), *An Inquiry Into the Nature and Causes of the Wealth of Nations (A Select Edition)* (1993) book V, ch II, pt II 'Of Taxes' 451–454; Adam Smith in *The Wealth of Nations* 1776 sets out four canons of taxation, which are:

(i) each should contribute to the support of the State in proportion to their ability and therefore in proportion to the revenue they enjoy under the protection of the State;

> We may live in a tax world reminiscent of Alice in Wonderland—where the tax law vanishes just when it is becoming vaguely familiar, to be replaced by some other extraordinary tangle of concepts and rules—but it is remarkable how the basic principles that should underlie a tax system change very little.

To that end, 200 years later, similar principles as espoused by Adam Smith have been applied by the:[39]

- Henry Review (2010)—'goals of fairness, efficiency, simplicity'[40]
- UK Mirrlees Review (2010)—'[a]ll tax systems strive for fairness or equity—with commonly stated goals of treating equal individuals equally (horizontal equity)'[41]

> (ii) the tax each individual pays ought to be certain and not arbitrary;
> (iii) tax ought to be levied at a time convenient to the contributor; and
> (iv) taxes should take out and keep out of the pocket of the payer as little as possible in excess of what they bring into the treasury.

Clinton Alley and Duncan Bentley, 'A Remodelling of Adam Smith's Tax Design Principles' (2005) ePublications@bond < http://epublications.bond.edu.au/law_pubs/45/>; also Adrian Shipwright and Elizabeth Keeling, *Textbook on Revenue Law* (2nd ed, 1998) to some extent interpret Smith's works. For example, as to the first canon, they state it to be 'described in the modern literature as equity' [1.4.2]. As to the third canon, they state:

> The modern jargon for this is that the tax should be neutral. By this it is meant that the system should be designed to minimise, as far as possible, the impact of the tax structure on the economic behaviour of agents in the economy and that it should avoid distortionary substitutional effects.

[37] In his original 1776 publication, Adam Smith set out four principles, being: equity, certainty, convenience and economy.

[38] Alley and Bentley, above n 36, 581. As to simplicity, see Neil A Warren, 'Modelling the Economic Outcomes from TVM—Is it Practical and Meaningful?' in Yuri Grbich and Neil A Warren (eds), *Tax Value Method Consultative Conference* (2001) 197, 205–206.

[39] The US tax system was recently considered in Quynh T Nguyen, 'The Most Efficient Tax Policy: The Federal Tax System v The Fair Tax Policy' (2011) 5 *Rollins Undergraduate Research Journal* 1 <scholarship.rollins.edu/cgi/viewcontent.cgi?article=1029&context=rurj>.

[40] Australia's Future Tax System Review (Ken Henry, Chair), *Australia's Future Tax System: Report to Treasurer* (Released 2 May 2010) 15 (AFTSR, or commonly called the Henry Review). As well as discussing 'equity', 'efficiency' and 'simplicity' (see below), it stated two additional factors:

> **Design principles for the tax and transfer system**
> **Sustainability**
> The tax system should have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes. To be sustainable the tax system, together with the transfer system, must contribute to a fair and equitable society. The cost of the transfer system needs to be predictable and affordable in the light of demographic change. Sustainability also means that the structural features of the system should be durable in a changing policy context, yet flexible enough to allow governments to respond as required. Legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system. Policy settings should also contribute to environmental outcomes that are sustainable.
> **Policy consistency**
> Tax and transfer policy should be internally consistent. Rules in one part of the system should not contradict those in another part of the system. To the extent possible, tax and transfer policy should also be consistent with the broader policy objectives of government. However, the primary objectives of the tax and transfer system, to raise revenue and provide assistance to those in need, should not be compromised by other policy objectives.

- UK Meade Report (1978)—'efficiency … simplicity and costs of administration and compliance, flexibility and stability …'[42]

- Asprey Report (1972)[43]—'for brevity, these aims may be referred to as efficiency, fairness and simplicity'.[44]

The Commonwealth Treasurer directed the Ralph Review to 'be consistent with the aims of improving the competitiveness and efficiency of Australian business ... improving simplicity and transparency and reducing the cost compliance'.[45]

These three principles, as are relevant to succession planning, are set out below.

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[41] Dimensions of Tax Design (Sir James Mirrlees, Chair), *The Mirrlees Review* (Oxford University Press, 2010) <http://www.ifs.org.uk/mirrleesreview/dimensions/mirrlees_dimensions.pdf> 175.

[42] J E Meade, *The Structure and Reform of Direct Taxation: Report of a Committee* (J E Meade, Chair) (1978) 7:

> We consider the most important of these under the following six headings:
>
> - Incentives and economic *efficiency* • Distributional effects • International aspects • *Simplicity* and costs of administration and compliance • Flexibility and stability • Transitional problems [Italics added].

The Meade Report adds additional principles as a touchstone for a taxation system. John Tiley, *Revenue Law* (4th ed, 2000) lists them as:

> the effects on economic incentives; its fairness as between persons of similar taxable capacity; its effects upon distribution between rich and poor; whether it is compatible with desirable international economic relations; and its simplicity, ease of understanding and absence of excessive administration costs [1.3.1].

John Tiley, in the same source, also provides a helpful discussion of the modern relevance of the Meade Report.

[43] Taxation Review Committee (Asprey, Chair), *Full Report* (AGPS, Canberra, 1975) (Asprey Report). The Asprey Report sets out two additional principles, being growth and stabilisation. 'Equity, simplicity and efficiency seem to the Committee the three dominant tests of merit for individual taxes and for the tax system as a whole', ch 3 [27].

[44] Dirkis and Bondfield, above n 34, 431 stated that 'in the first eighty years of the Commonwealth's income tax, official independent tax reform inquiries were launched every decade or so'. These include: 1920—Royal Commission on Taxation (W Kerr, Chair), *Reports* (Australian Government Printer, Canberra, 1921 to 1923); 1933—Royal Commission on Taxation (D Ferguson, Chair), *Reports* (Australian Government Printer, Canberra, 1933 to 1934); 1950—Commonwealth Committee on Taxation (ES Spooner, Chair), *Reports* (Australian Government Printer, Canberra; 1951–1953); 1955—Commonwealth Committee on Rates of Depreciation (AS Hulme, Chair) *Reports* (Commonwealth Government Printer, Canberra, 1955); 1961—Commonwealth Committee on Taxation (G Ligertwood, Chair) *Reports* (Commonwealth Government Printer, Canberra, 1961); 1975—Taxation Review Committee (Asprey, Chair), *Full Report* (AGPS, Canberra, 1975) (Asprey Report); 1975—Committee of Inquiry into Taxation and Inflation (Mathews, Chair), *Reports* (AGPS, Canberra, 1975); 1984—Economic Planning and Advisory Committee (EPAC), *Reform of the Australian Tax System*, Draft White Paper (AGPS, Canberra, 1984); 1985—Treasurer, Commonwealth, *Reform of the Australian Taxation System: Statement by the Treasurer* (AGPS, Canberra, 1985); 1998—*Tax Reform, Not a new tax, a new tax system* (ANTS) (AGPS, Canberra, 1998); 1999—*Review of Business Taxation, A Tax System Redesigned* (Ralph Review) (AGPS, Canberra, 1999); 2001—*Review of International Taxation Arrangements* (RITA) (AGPS, Canberra, 2001); 2010—*Australia's Future Tax System: Report to the Treasurer* (Henry Review) (Ken Henry, Chair) (AGPS, Canberra, 2010).

[45] *Review of Business Taxation, A Tax System Redesigned* (Ralph Review) (AGPS, Canberra) v, vii.

1 Efficiency—Encourage Economic Growth

The aim of efficiency in taxation is to 'raise and redistribute revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs'.[46] Failure risks economic growth.[47] Such 'costs represent a net loss to society as a whole'.[48] In addition, the taxation system 'affects the choices people and businesses make'.[49] This includes the 'choice of a business structure', such as the formulation of a succession plan, and 'investing in long-lived productive assets', such as the insurance.[50]

The Asprey Report stated that 'neutrality should be the general aim when efficiency is under consideration'.[51] Taxation should seek to be 'neutral and equitable' between 'forms of commerce'.[52] Neutrality requires that 'taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation'.[53] However, the Asprey Report stated that life insurance is so beneficial to the community that it should be made an exception to 'neutrality'.[54] The Asprey Report stated that life insurance should be treated in a similar fashion to superannuation (which has numerous taxation exemptions and benefits).[55] Rather than seek neutrality, the taxation system should bias

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[46] Henry Review, above n 40, 7.

[47] Economic growth is a factor to be taken into account for a tax system. See Warren, above n 38, 206; and also Review of Business Taxation, *A Strong Foundation: Discussion Paper 1: Establishing Objectives, Principles and Processes* (John Ralph, Chair) xviii. Also known as the Ralph Report, it stated that:

> The pre-eminent economic challenges for Australia remain those of lifting its sustainable growth performance and enhancing job creation. A more efficient business tax system can contribute vigorously to those goals by redirecting business energy and commitment more productively.

The Meade Committee also acknowledged that the taxation system affects 'economic opportunities and incentives'. Meade, above n 42, 9 stated that:

> over a large tax base may be assumed to cause less marked 'substitution' distortions than to raise the same revenue by concentrating high rates of tax on a few activities, unless special circumstances suggest that those particular activities show exceptionally low substitution sensitivities.

[48] Henry Review, above n 40, 7.

[49] Ibid.

[50] Ibid.

[51] Asprey Report, above n 43, ch 3[26]. Ian McAuley, *The Case for Restoring Capital Gains Tax Neutrality* (Taxwatch, University of Canberra and Centre for Policy Development, 14 July 2009) 2 stated that 'neutrality is desirable on both efficiency and equity grounds'. Neutrality is considered under the heading of efficiency. (While the McAuley article is undated on the Taxwatch website, the author has advised that he submitted his paper to Taxwatch on 14 July 2009).

[52] Alley and Bentley, above n 38.

[53] Ibid.

[54] Asprey Report, above n 43, ch 21[4].

[55] Ibid., ch 21.1–.2, where it stated that:

> On another level, life insurance and superannuation give financial protection to the individual and those dependent upon him in the event of death or retirement. To this extent, they provide benefits that society has come to regard as desirable.
>
> 21.2 For these reasons the Committee believes that, generally, life insurance and superannuation should not be dealt with in isolation from each other and that the tax treatment of one should be consistent with the tax treatment of the other. This is not to say, however, that the basis of the taxing both should necessarily be identical.

behaviour to invest in insurance. Justifying a departure from the requirement of neutrality, the Asprey Report stated that:[56]

> the taxation of life insurance must be considered as a whole. There must be harmony between the treatment of premium payments, the income of the life insurance fund and the payment of policy proceeds. No one element can be looked at in isolation from the other two. Second, unlike the situation with superannuation benefits, it is neither feasible nor desirable to tax the proceeds of a life insurance policy ... Thirdly, if it is desired that life insurance be encouraged there is justification for giving some form of concession related to the payment of the premiums.

The Federal Court in *NM Superannuation Pty Ltd v Young*[57] also noted the special importance of life insurance to provide for retirement, old age and the maintaining of dependants, where Burchett J, citing *Re Lin; Law v. Lin*, stated that:[58]

> The legislatures of Australia, of both Colony and State have passed many enactments relating to life assurance policies designed to encourage thrift and to enable persons to make provision for their dependants.

These favourable taxation concessions are considered further in Chapter Five. The justification for departure from neutrality is examined in Chapter Seven.

2 Simplicity—Simple to Understand for Regulator and Taxpayer

Simplicity is a factor for both the taxpayer and the regulator. The Asprey Report stated that a tax is simple if 'the cost of official administration is small, and if the "compliance costs", the cost in money and effort ... to the taxpayer, are also small'.[59] The Henry Review also acknowledged that 'a simple and transparent system may also involve lower compliance costs for taxpayers'.[60] The taxation system 'should be easy to understand'.[61]

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[56] Ibid., ch 21[160–162].
[57] (1993) 113 ALR 39, 41 FCR 182.
[58] *Re Lin; Law v. Lin* (1960) 18 ABC 142, 143.
[59] Asprey Report, above n 43, ch 21[160–162].
[60] Henry Review, above n 40, 7.
[61] Ibid.

An outcome of simplicity is that 'people and businesses will be more likely to make the most beneficial choices for themselves'.[62] The Meade Report stated that the taxation system should be 'coherent, simple and straightforward' as to the administration and compliance.[63] Certainty is required as to what is taxed and by how much.[64] The taxpayer should be able to comprehend 'the purpose which [the tax] is intended to serve'.[65] The Asprey Report stated that 'uncertainty entails the costs of consultation with experts'.[66] Drawing evidence from the historical review presented in Chapter Three, the research considers whether the taxation laws are ambiguous and uncertain. Such qualities may hamper and reduce the business owners' willingness and ability to enter into insurance-funded succession plans.

3 Equity and Fairness

Equity or 'fairness'[67] is described in the Asprey Report as having two limbs:[68]

> Horizontal equity, which means that people in similar economic circumstances should be treated similarly; and
>
> Vertical equity, which means that people in different situations should be treated differently, with those who are better off bearing a greater share of the tax burden.

The Henry Report stated that:[69]

> the tax and transfer system should treat individuals with similar economic capacity in the same way … considerations about the equity of the system also need to take into account exposure to complexity and the distribution of compliance costs and risk.

In the context of succession planning, owners should be treated equally. The structure and distributive effects of the taxation of the insurance are examined. The research considers for the taxation of insurance any disparate tax treatment between the different

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[62] Ibid.
[63] Ibid.
[64] Ibid., 19; see also the same sentiment in the Review of Business Taxation, above n 47, xvii.
[65] Meade, above n 42, 18, 19.
[66] Asprey Report, above n 43, ch 3[20].
[67] Ibid., 14.
[68] Ibid.
[69] Henry Review, above n 40, 7.

ways to structure the succession plan (see Chapter Five) and the different models in which to hold and own the insurance (see Chapter Six).

4 Conclusions as to the Taxation Benchmarks

The Asprey Report stated that 'each tax will have its own distinct merits and defects when judged by the various criteria commonly applied to taxation'.[70] Nevertheless, the research considers the taxation treatment of insurance in succession planning against the general principals of efficiency, simplicity and equity. The taxation aspects are benchmarked against the criteria detailed below.

(a) Efficiency

Insurance-funded succession planning seeks to help small businesses continue after a principal's death or disability. Taxation should not unjustifiably hinder any part of the succession planning process. It should be the 'least detrimental to economic growth'.[71] Two aspects of neutrality are used as criteria. First, the taxation system should avoid enticing expenditure away from succession planning and the taxation of insurance should be similar irrespective of the business vehicle used; whether a partnership, trust, company or superannuation fund. Second, based on the Meade Report's suggested special treatment of life insurance, the tax system should have a bias towards encouraging owners to invest in life insurance as a way of funding the succession plan.[72]

(b) Simplicity

Ideally, the taxation rules and policies for succession planning insurance should be simple and straightforward for small business owners; that is, the 'man and woman in the street [should be able to] comprehend clearly [as to] what is the nature of the taxpayer's liability'.[73] The rules and policies should also be easily administered by the regulator.

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[70] Asprey Report, above n 43, 11.
[71] Henry Review, above n 40, 16.
[72] Total neutrality is not always a universal aim. See Warren, above n 38, 205–206.
[73] Meade, above n 42, 18.

(c) Equity and Fairness

As discussed above, particularly regarding horizontal equity, people in similar economic circumstances should be treated, from a tax perspective, alike.[74]

The research considers the value of the tax system encouraging insurance-funded succession plans. This supports small business viability when a principal dies or is disabled. In Chapter Five, the research asks whether the current tax treatment of insurance in succession planning unduly reduces the number of insurance-funded succession plans. For example, the research considers whether the premiums on insurance for succession planning should be deductible and whether the definition of 'life insurance' for tax purposes should include TPD and trauma. In Chapter Seven, the research examines whether insurance used for succession planning should be given special relief from taxation, based on the criterion of neutrality under both taxation benchmarks of efficiency, and equity and fairness.

F. Structure

The research is structured as follows. Chapter One sets out the research and the manner in which it is approached, including the establishment of the taxation benchmarks. Chapter Two assesses the importance of succession planning and the insurance for the economy. Chapter Three sets the platform from which to examine the taxation treatment of succession planning by providing an historical study of insurance, as it relates to succession planning, and an historic account of succession planning.

To highlight potential taxation issues, Chapter Four considers timing issues for CGT, while Chapter Five considers the taxation effects on the insurance premiums and proceeds. The final section of Chapter Five and Chapter Six consider the demise of the traditional cross-ownership of the insurance model using a mandatory buy-sell agreement and the failure to find a replacement. Anomalies and inconsistencies are identified. The concluding chapter, Chapter Seven, draws the various criticisms and options together and provides a series of suggested recommendations for taxation system reform as it effects insurance-funded succession planning. The recommendations

[74] Shipwright and Keeling, above n 36.

seek to improve the taxation treatment of the succession planning process with an emphasis on insurance as the funding mechanism.

The law is as stated at 1 January 2012.

CHAPTER TWO: CONSEQUENCES OF A PRINCIPAL'S DEATH OR DISABILITY AND THE VALUE OF BUSINESS SUCCESSION PLANNING

A. Introduction

Chapter One set out the taxation benchmarks against which the taxation of insurance in a business succession plan may be judged. After defining the concepts of 'owner' and 'principal', this chapter discusses the consequences of a principal's death or disability and the value of succession planning for small businesses to the owners and their employees. It also explains why the ongoing viability of a small business is important to the economy. The chapter demonstrates that a small business can be unique, in that a principal's death or disability may put the otherwise viable business at greater risk than would be the case in a larger business. The chapter highlights how the insurance-funded succession plan helps reduce such risks and supports business continuation. Because of the importance and value to the economy of insurance-funded succession plans, taxation concessions by the Government are considered.[1]

B. The Concepts of 'Owner' and 'Principal'

For the purposes of the research, the terms 'owners' and 'principals' are used to describe the parties to the succession planning agreement. The 'owners' are the persons with the legal title to the business.[2] The owners can be individuals or companies in their own capacity or trustees of trusts.[3] For reasons such as asset protection, the owners may wish to divorce themselves from the day-to-day management of the business. For example, where the owner is an individual, he or she may prefer the other spouse to manage the business. These managers are referred to as the 'principals'.

[1] This is for insurance, as suggested in the Asprey Report, discussed in Chapter One.

[2] The owner may or may not also be the holder of the equitable interest in the business. For example, the owner may merely hold the business interest as trustee of a trust and have no equitable interest in the business. This is not relevant for the purposes of the research, as the owner is assumed to have authority to bind the persons holding the equity interest in the business when that owner signs the succession planning agreement.

[3] 'Individuals' or 'natural persons' are terms as opposed to artificial, legal or juristic persons, such as companies or incorporated associations.

'Principals' are the individuals who manage the day-to-day business operation. The principals are the persons insured for death, TPD and trauma. For example, '*principal A*' controls the interest in the business through a family trust with a company as trustee. *Principal A* is the principal (the individual who works in the business); the legal owner is the company, the beneficial/equitable owners are the beneficiaries of the trust. In the same business, *principal B's* spouse owns the business interest. *Principal B* is the principal; the owner is the spouse. The owner and principal can also be the same person. In that case, upon the principal's death, the principal may leave the business interest in a Will to a charity. In that instance, the executor of the principal's estate becomes the owner and subsequently the charity becomes the owner.

The principal who dies or is disabled is the 'outgoing principal' and the related owner is the 'outgoing owner'. The principals who do not suffer death or the disability are the 'remaining principals' and their owners are the 'remaining owners'. For example, if *principal A* dies, *principal A's* company is the outgoing owner. Under the succession plan's contractual obligations, *principal A's* company sells its interest in the business to the remaining owner (*principal B's* spouse) in exchange for receiving the insurance proceeds.

C. Consequences of a Principal's Death or Disability

Small businesses may suffer if they do not plan for a principal's death or disability. Consequences may include:

1 The outgoing principal, as a manager, may need to be replaced by another manager. When compared to larger businesses, small businesses may depend more 'upon the personal characteristics, abilities and resources of the owner-manager'.[4] Such dependency may be less in a larger business in which there is a larger hierarchy of managers and systems. For example, in a publically listed

[4] Rolffe Peacock, 'Failure and Assistance of Small Firms' *Understanding Small Business* (Submission relating to Bureau of Industry Economics, 2000) 6.

company, if an executive director dies or is disabled then the board, as it sees fit, merely replaces that director.[5]

Further, if the outgoing principal had specific skills or qualifications peculiar to that small business, trade or profession, especially skills that the remaining principals do not possess, then a replacement may need more than just general management skills.[6] He or she may also need to possess skills or qualifications specific to that business, trade or profession.

Moreover, because of licensing requirements, when a principal dies, the outgoing owner may not be permitted to continue to own an interest in the business. For example, the *Pharmacy Control Act 2001* (Tas) sections 62(1) and 65 require that only a registered pharmacist or body corporate (where the controlling interest is held by the registered pharmacists and all the other body corporate members are related parties or a spouse of the pharmacist) can hold an interest in a pharmacy.[7] In these circumstances, the outgoing principal's spouse needs, by law, to dispose of the business interest, unless the spouse is also a 'registered pharmacist'.

2 A principal's death or disability may cause any business loan or overdraft facility to default.[8] For example, in *Whiteley v Hodge*, the mortgage stipulated that:[9]

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[5] Where an executive director owned or controlled shares in the company, then the director's executor may continue to hold those shares. For example, the co-founder, chairperson and chief executive officer of Apple Inc., Steven Paul Jobs, died on 5 October 2011. Shortly before his death, a new chief executive officer was appointed. There was little change in the share price. Apple Press Information, <http://www.apple.com/pr/library/2011/08/24Steve-Jobs-Resigns-as-CEO-of-Apple.html>.

[6] As to a small business, an example of such a skill may be a baker in a bakery. As to a trade, for example, the business may be engaged in building and the principal may need to be a licensed builder. Finally, as to a profession, for example, in respect of medical practitioners, the *Health Practitioner Regulation National Law (NSW)* prohibits a non-registered person from holding themselves out as a health practitioner (s 116), and health practitioners who are not registered as medical practitioners from holding themselves as such (s 117).

[7] 'Related parties' are limited to the spouse, father, mother, son, daughter, grandson, granddaughter, brother or sister of the registered pharmacist: *Pharmacy Control Act 2001* (Tas) s 61A(3).

[8] See, for example, St George Bank's 'General Standard Terms—(08/2010 version)', which stated that:

> 21.1 You must: … (n) notify us if any guarantor who is an individual, dies.
>
> 42 You must: ... (b) not without our consent … cease conducting your business.
>
> 45 You are in default if: … (m) a person is appointed to investigate or manage your affairs or the affairs of a guarantor [such as an executor or administrator].

[9] [2000] NSWSC 866, 873.

> The Mortgagor will pay to the Mortgagee the mortgage debt or so much thereof, as shall remain unpaid immediately upon the sale of the mortgaged land or upon the death of the mortgagee, whichever is the earlier.

Death does not necessarily terminate the continuing guarantee.[10] Nor does death act as a notice of termination of a guarantor's obligation.[11] A principal ceasing to work in the business may also be a default, requiring the business to pay immediately all moneys owing under the loan or overdraft.[12] The risk may be greater if the owner's non-business assets (such as the family home) secures the loan.[13]

3 The remaining owners may not want the outgoing owner and outgoing principal, (if alive) to be involved in further ownership and management of the business. Further, there may be disputes within the outgoing owner's family as to who owns, or should own, the business interest.[14] In those circumstances, the remaining owners may not be certain with whom they are to negotiate. In the US, as in Australia, in the absence of a succession plan, the spouse or next of kin may control the outgoing principal's business interest. This may be an unpalatable outcome, in that:[15]

> what most businesses do not see as a viable solution [to the death, disablement or retirement of a principal] is having the spouse of the deceased, disabled or retired shareholder become a new partner in the business. Nor does the spouse of such a deceased, disabled, or retired shareholder generally want to jump into such a role.

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[10] See, for example, *Ronan v Australia and New Zealand Banking Group* [2000] VSCA 77, 81, in which the mortgage stated:

> Clause 27. That this Mortgage shall not be discharged or affected by the death … of the Customer or any one or more of them … or any principal debtor or by the death … of the Mortgagor … or by any change which may take place in the person or persons now or hereafter comprising any partnership or Firm for the time being constituting the Customer … or by any other circumstance or event but shall continue to be operative until actually discharged by the Bank.

[11] See, for example, Ibid., 52, where it was held that it is notice of, not merely the fact of, the death that will 'discontinue a continuing guarantee in respect of future advances'.

[12] See, for example, St George Bank's 'General Standard Terms—(08/2010 version)', which stated that:

> 45 You are in default if:
>
> (r) … more than 20 per cent of the partners retire in any 6 month period.

[13] The loss of a principal may also create uncertain reactions by creditors and clients of the business.

[14] Disputes can arise, such as challenges to Wills, Family Court (for spouse and de facto relationships), constructive trusts and ambiguity in aging trust deeds.

[15] Russell J Fishkind and RC Kautz, *Estate and Business Succession Planning: A Legal Guide to Wealth Transfer* (John Wiley & Sons, 2002) 187.

4 In Australia, partnership structures have additional risks when compared to other business structures. Where the business is operated through a partnership structure, upon the death of a partner, the partnership is immediately dissolved.[16] This is by force of State and Territorial laws.[17] This is unless there is an agreement to the contrary. Otherwise, following the partner's death, the partnership only remains 'on foot' to the extent necessary to wind up the business.[18]

In this event, the beneficiaries do not obtain beneficial ownership of any particular partnership asset.[19] It is not possible, without specific agreement, for the beneficiaries to take a discrete portion of any of the partnership assets and dispose of them. In the absence of an agreement, the entire business is terminated and its assets liquidated for each partner to receive their distribution in cash.[20] This would not necessarily be the remaining owners' preferred outcome; they may wish to continue operating the business after the principal's death or disability.

A forced sale of the partnership assets may also not be the outgoing owner's desired outcome, as the only potential purchaser may be the remaining owners. If there is no other potential purchaser, the remaining owners may be able to acquire the partnership assets for a low price. Alternatively, rather than seek to acquire the partnership assets, the remaining owners may instead merely establish a new business in a new business structure.[21] The beneficiaries of the

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[16] An additional risk is that the death of a partner is generally a default of an overdraft facility. See, for example, St George Bank's 'General Standard Terms—(08/2010 version)', which stated that:

> 45 You are in default if: …
>
> > (r) if you, or a guarantor, is a partnership, that partnership is dissolved, an application is made for its dissolution.

[17] In Australia, partnership law is generally not under the control of the Commonwealth. Rather, it is under the control of the individual States and Territories.

[18] *Partnership Act 1963* (ACT) s 38; *Partnership Act 1892* (NSW) s 33; *Partnership Act 1997* (NT) s 37; *Partnership Act 1891* (Qld) s 36*; Partnership Act 1891* (SA) s 33; *Partnership Act 1891* (Tas) s 38; *Partnership Act 1958* (Vic) s 37; *Partnership Act 1895* (WA) s 44.

[19] CCH Tax Editors, *Australian Federal Tax Reporter* (CCH Australia Ltd, Daily Online Update) [902-260].

[20] A clause in the contract may address this issue. Such a clause could state that the partnership is not dissolved on the death or retirement of a partner, but is to continue as a partnership between the surviving partners.

[21] However, the partners are bound by legal and fiduciary obligations not to take assets from the old partnership. Such assets may include client lists, knowhow and systems. However, there are no requirements to have restraint of trade requirements in partnership agreements. In this case, the remaining owners may be free to set up again in a similar business with the personal benefit, skills and training that they obtained while working in the partnership.

deceased principal could then be left with a business interest that has little or no value.[22] In any event, if there are no willing third party purchasers the partnership assets may have little value.

Further, if the remaining owners continue to operate the partnership after the outgoing principal's death, the outgoing owner may be entitled to the profits.[23] This is the case even though the outgoing principal did not contribute to the partnership during that period.

Finally, each partner in a partnership is responsible for and has unlimited liability for the actions of the other partners.[24] This joint and several liability adds extra risks less associated with other business structures, such as companies (which have limited liability for shareholders) or trusts[25] (where the trustee is normally liable, rather than beneficiaries).[26] This unlimited liability would concern a prudent executor of the deceased principal's estate.[27] The executor, to limit exposure, may seek to wind up the partnership expeditiously. Maximising the purchase price in any proposed sale may be secondary to the executor's fiduciary obligation to extract the deceased estate from the threat of unlimited liability at the earliest opportunity. The remaining owners may not share this approach.

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[22] Peter White and Ian MacPherson, *Business Succession Planning Buy/Sell Agreements* (Taxation Institute of Australia, 20 September 2006) 15.

[23] CCH Tax Editors, above n 19.

[24] This may be limited to such actions and conduct as concern the partnership business.

[25] However, as for unit trusts, in *Broomhead Pty Ltd (in Liquidation) v Broomhead Pty Ltd* (1985) VR 891, Justice McGarvie stated that the unit holders in a unit trust were liable to indemnify the trustee against liabilities incurred in carrying on a business. In this case, the share of each beneficiary's liability was limited to the proportion of his or her beneficial interest.

[26] *Partnership Act 1892* (NSW) s 12:

> **Liability for wrongs joint and several**
>
> 12 Liability for wrongs joint and several
>
> (1) Every partner in a firm other than an incorporated limited partnership is liable jointly with the partner's co-partners and also severally for everything for which the firm while the partner is a partner therein becomes liable under either of the two last preceding sections.
>
> (2) Every general partner in an incorporated limited partnership is liable jointly with the other general partners in the partnership and also severally for everything for which the firm becomes liable under section 10 (3) or 11 (2) while the general partner is a general partner in the firm.
>
> (3) Despite [sub-]section (2), a general partner in an incorporated limited partnership is only liable for any liability of the incorporated limited partnership referred to in that section:
>
> (a) to the extent the incorporated limited partnership is unable to satisfy the liability, or
>
> (b) to a greater extent provided by the partnership agreement.

[27] The executor would be concerned, as the estate remains liable for the remaining owners' activities as they concern the partnership.

5 The outgoing owner (and outgoing principal, if alive) may want to continue to own and manage the business. The outgoing owner may have, for example, a family member (such as an out-of-work child with no qualifications or skills related to the business) ready to step in to replace the outgoing principal or 'you might find that the deceased principal's spouse—who is not suited to running a business—wishes to become involved in a significant way'.[28] From the outgoing owner's perspective, this may be important to help secure the payment of the outgoing principal's regular 'salary' or 'drawings'. It also allows the outgoing owner to maintain surveillance of the business. The remaining owners may not find that acceptable.

6 A related issue to the above is that 'the business might continue to be run for the benefit of both families with only one family doing all the work'.[29] The outgoing owner may be prepared to continue to hold the business interest, although the remaining owners, again, may not find that acceptable.

7 Conversely, as the principal is no longer working in the business, the outgoing owner may not want ongoing involvement in the management and ownership of the business and may wish to sell the business interest. However, there may be no ready market for an interest in a small business,[30] 'as the business interest lacks the large ready market that exists for publically traded securities'.[31] If a willing purchaser is found, it may be difficult for the outgoing owner to value the interest in the business now that the outgoing principal is no longer working in the business.

8 Even if the outgoing owner finds a willing third party purchaser at an agreed purchase price, the sale may be subject to certain restrictions. Zaritsky stated that, in the US:[32]

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[28] Bernie O'Sullivan, *Estate & Business Succession Planning 2011–12* (Taxation Institute of Australia) 349.
[29] Ibid.
[30] Fishkind and Kautz, above n 15, 189; see also Albert E Ellentuck, 'Tax Planning for Buy-Sell Agreements' (1996) 84 *Nation's Business* 3, 1.
[31] Howard M Zaritsky, *Structuring Buy-Sell Agreements* (Warren, Gorham & Lamont, 2nd ed, 2000) 1.02[2].
[32] Ibid., 1.01.

> Buy-sell agreements are contracts by which the owners of a business (stockholders or partners) agree to impose certain restrictions on their right to transfer their interest in the business freely to whomever they wish, whenever they wish, and on whatever terms they wish.

Equally, in Australia, pre-emptive rights are a common restriction in company constitutions, shareholder's agreements and unit trust deeds.[33] They generally require every offer that is acceptable to the outgoing owner to be first presented to the remaining owners. The courts have set a high standard on the presentation of a pre-emptive right offer to the remaining owners:[34]

> [It] … is not valid unless it is ... clear and unambiguous. By this I mean, not that its import must be clear beyond the slightest peradventure, but that its terms must be such that a reasonable person, having given it fair and proper consideration, would be left in no doubt as to its meaning.

The pre-emptive right may give the remaining owners a set amount of time to match the agreed price and terms of the offer, or lose that right of purchase. If the remaining owners accept the offer, they then acquire the interest in the business instead of the potential third party purchaser. If the remaining owners do not accept the offer or let it lapse, then the outgoing owner is at liberty to sell the business interest to the third party on the same terms of sale.

The requirements of the pre-emptive rights may make it harder to find a third party purchaser willing to wait on the decision of the remaining owners. In addition, as shown in *Allmere Pty Ltd v Burbank Trading Pty Ltd*[35] ('*Carpet Call*'), pre-emptive rights can add another level of complexity. In the *Carpet Call* case, the parties entered into a shareholder's agreement that contained pre-emptive rights. The court considered whether:

[33] Pre-emptive rights exist in most shareholder and unit holder agreements, proprietary limited company constitutions and unit trust deeds. See also F Hodge O'Neal and Robert E Thompson, *O'Neal's Close Corporation* (3rd ed, 1987) ch 7.

[34] *Catley v Watson* [1981] V ConvR [54-003] (Victorian Court of Appeal).

[35] [2008] VSC 139, Supreme Court of Victoria, Hollingworth J, 2 May 2008.

1 the transferor had already bound itself to sell to the third party before the pre-emptive notice was sent;

2 the pre-emptive notice was invalid because it did not reflect a *bona fide*, arm's length price for the shares;

3 the pre-emptive notice failed to give the full details of all dealings affecting the proposal to transfer the shares; and

4 the pre-emptive procedure failed on an interpretation of what constituted 'earlier than 30 days after the expert determination of the price for the purposes of the deemed offer notice'.

There have been other legal disputes relating to pre-emptive rights.[36]

If the remaining owners are unable or unwilling to match the purchase price and terms of the offer and accept the offer, then the third party purchases the business interest. The remaining owners may now have a new co-owner who does not share their goals, aspirations and direction. In *Friend v Brooker*, the parties were first partners and then directors in a company.[37] One party took out loans that benefited the business. The High Court held that the other party was not liable for those loans and that no fiduciary obligations arose in respect of that matter. The case demonstrates that a number of activities can be undertaken for which, in both a partnership and company structure, there is not necessarily a fiduciary obligation requirement.

Further, the new co-owner may be intent on harming the remaining principal's position in the company. In *Agranoff v Miller*, the court stated that:[38]

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[36] See, for example, *Centro Property Trust (Centro) for AMP Shopping Centre Trust (ART): AMP Shopping Centre Trust 01* (2003) 21 ACLC 1, 696; *APT SEA Gas Holdings Pty Ltd v ANP SEA Gas Holdings Pty Ltd* [2010] NSWSC 1221. The major issue in this latter decision was whether the acceptance given by APT was unconditional.

[37] (2009) 27 ACLC 781; [2009] HCA 21.

[38] 1999 WL 219650 (De Ch Ct 1999), affirmed as modified by 737 A2d 530 (Delaware Superior 1999) 1.

> [the incoming owner] ... in conspiracy with two faithless ... fiduciaries ... wrongfully obtained his shares ... improperly utilized confidential corporate information to which he, as a corporate outsider, had no rightful access; and usurped corporate opportunities that belonged to ... [the business].

In this case, upon the transfer of the shares, in breach of the pre-emptive rights, the incoming owner, with majority control, sacked the remaining principals from the board.[39]

In the US, a commentator has stated that the succession plan 'prevents the sale ... outside the present ownership group ... and it is often the paramount reason for using buy-sell agreements'.[40] For whatever reason, 'unrelated persons rarely want to be forced into a close business relationship with a stranger or competitor'.[41]

9 While pre-emptive rights give greater control to the remaining owners, the Family Court may override the pre-emptive rights. For example, in *In the Marriage of Susan D Devick*, shares were transferred to the wife pursuant to a Family Court order.[42] Upon receipt of the share certificates, without her knowledge, the shares had restrictions placed on them that stopped her from disposing of the shares. The court ordered that the restrictions be removed. However, the court did note that the transfer 'restrictions were not in the ordinary course of business'.[43]

Under *Family Law Act 1975* (Cth), section 4AA(1), Family Court orders relate to not only married couples, but also couples in de facto relationships of both the same and opposite sex.[44] In *Green v Green*,[45] the court stated that a person could live in three simultaneous domestic relationships. In that case, Mr Green had one

[39] However, the court overturned the transfer of shares back to the outgoing owner.
[40] HM Zaritsky and SR Leimberg, *Tax Planning with Life Insurance* (Warren Gorham Lamont, 1992) 7–25.
[41] Zaritsky, above n 31, 1.02[2].
[42] *In the Marriage of Susan D Devick* (2000) 315 Ill App 3d 908, 735 NE2d 153, 248 Ill Dec 833.
[43] Zaritsky, above n 31, 1.05.
[44] Commonwealth laws for the division of property for people in *de facto* relationships came into force on 1 March 2009. Therefore, the *Commonwealth Family Law Act 1975* now applies to both married and *de facto* couples, as well as same-sex couples.
[45] (1989) DFC [95-075], (1989) 13 Fam LR 336 (Full Court of the Supreme Court of NSW). Mr Green died at 23 years of age.

lawful and two de facto wives and seven children, and maintained simultaneous domestic establishments with all three women and their respective children. It is possible, at the same time, for one person to have a spouse, a de facto of the opposite sex and a de facto of the same sex.[46] All three persons could potentially make a claim for, and have an interest in the, ownership of the business through the Family Court.[47]

10 The outgoing owner may have had little involvement with the business. With the loss of the principal, the outgoing owner may have limited commercial skills to negotiate a sale and value the business.[48] The perception of the value of the business may be susceptible to emotional complications due to the loss of a spouse and the grieving process. This may be the case where the potential purchasers are the remaining owners who, in the eyes of a surviving spouse, worked the dead spouse 'to death'.

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[46] See, for example, *Jonah & White* [2011] FamCA 221, where Murphy J held that Ms Jonah and Mr White were deemed to be in a *de facto* relationship. This was the case even though Mr White was married and living with his wife and three children, Ms Jonah and Mr White's relationship was a secret, Ms Jonah lived in her own home, the parties generally kept their finances separate and they had no children together.

[47] See, for example, *Cooper v Voss and Voss* (1984) FLC ¶91-536 (1984), where a 'stranger' made a claim in relation to children. The 'stranger' would now be considered a *de facto* spouse under current laws. In *Re Fagan deceased* (1980) 23 SASR 454, a female successfully obtained a declaration under the *Family Relationships Act 1975* that she was the deceased's putative spouse, even though the deceased had been living a double life and was married at the same time, with two legitimate children. See also *In D v McA* (1986) DFC ¶95-030. Similarly, the New South Wales Law Reform Commission, in its Report on *De Facto Relationships* 310–311 stated:

> 17.14 Is cohabitation with a spouse consistent with concurrent cohabitation with a de facto partner? And, can a person be a party to more than one concurrent de facto relationship? If regard is had to the terms of the basic definition, it is conceivable that in some cases affirmative answers would be given to both questions.

[48] While this research does not deal with valuation or valuation methods of the outgoing owner's interest, in AR Fantini, RA Esperti and RL Peterson, *Love, Money, Control: Reinventing Estate Planning* (Esperti Peterson Institute, 2004) 385, the authors give an excellent summary of issues to take into account, including 'discounts' in valuing the outgoing owner's interest in the business:

> In valuing a privately owned business enterprise, the appraiser may adjust the value based on the following discounts:
>
> - *Lack-of-marketability discount*: This discount reflects the inherent difficulty in marketing a business that is not registered for sale to the general public and is not freely traded on any stock exchange.
> - *Lack-of-control, or minority-interest, discount*: This discount is a reduction in value applicable to the valuation of an equity interest that represents less than 50 per cent of the ownership of the company. A valuation discount for non-controlling equity interests in a business recognizes that an investor will probably pay more for control and will pay less in the absence of control.
> - *Key-person discount*: The death or permanent disability of a key employee can be ruinous to a company. The key-person discount recognizes the potential reduction in income, and corresponding impairment of equity value, if business performance truly depends on the continued participation of the few key employees.
>
> The appraiser may also apply premiums to the value, such as a control premium, which is the converse of the lack-of-control discount. If an owner has more than a 50 per cent share of the business and the right to control it, a purchaser may be willing to pay more for control.

11 Even if the remaining owners are willing purchasers, they may lack finance and credit facilities to fund the purchase of the outgoing owner's business interest. The lack of funds is exacerbated if the business's overdraft facility is withdrawn coupled with the bank threatening to sell the owners' homes to satisfy the outstanding overdraft.[49] Without a source of funds at the required, usually unknown, time, there may be a loss of certainty in the succession plan. As stated in point three, the remaining owners may wish to remove the outgoing owner quickly. However, the outgoing owner may be less willing to relinquish the business interest until the full purchase price is paid. US commentator Professor Fahr stated that:[50]

> The problem has been to raise the cash to finance the purchase. To fund it by annual deposits for the purpose was never easy, and modern taxes make it harder. Furthermore, in most cases, the older member of the business will die first, and by an unhappy paradox, he is the one most likely to be able to raise the money for the purchase. Finally, if a death occurs before there has been a chance to build up a fund; such a purchase agreement will probably fail.
>
> Another manner of financing the agreement is to use long-term notes in payment for a deceased businessman's share. But, such notes are hardly a substitute for full payment in cash, and may be hard to meet in the period following a death while the business is getting going under a change of management.
>
> But, since the problem to be solved at this point is the raising of a large sum of ready cash at death, the twentieth century mind at once thinks of life insurance.

Succession planning has decreased certainty if the remaining owners lack the funds to purchase the outgoing owner's interest in the business. Therefore, a fundamental element of a successful succession plan is how it is funded.

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[49] This is as discussed in point 2 above.

[50] Samuel M Fahr, 'The Business Purchase Agreement and Life Insurance' (1950) 15 *Law and Contemporary Problems* 319, 320.

12 The outgoing owner may wish to continue to receive the outgoing principal's regular 'drawings' or 'salary'. This may be required to pay for the costs of sending children to private schools, buying food and clothes and meeting the home mortgage repayments. However, the business may be generating less income because of the loss of the principal, loss of the business loan or other reason. The remaining principals may hold the view that there is insufficient income available to pay the outgoing principal's 'drawings'. There may be confusion to whether the regular 'drawings' were paid because a principal worked in the business (akin to a salary) or because of the ownership in the business (share of profit, such as a monthly dividend). The remaining principals may contend that the business makes no 'profit', rather it just makes 'wages', and if a principal no longer works in the business (for whatever reason), then that principal is no longer paid. The outgoing owner may disagree, claiming that the monthly drawings were paid to the owners, not to principals and that the principals were never paid a wage or salary. The remaining owners may then argue that such a scheme was merely in place to reduce taxation. This may fall foul of the general anti-avoidance provision found in the *Income Tax Assessment Act 1936 (ITAA 1936*) Part IVA.[51]

13 Putting aside fiduciary obligations of trustees and company directors, if the remaining principals decide to leave a small business, the wealth of the business may follow that outgoing principal via personal goodwill, corporate knowledge and the principal's trade and professional knowledge. For example, a baker continues to know how to bake in the new enterprise and may still know the contact details of the employees. Likewise, an accountant knows the taxation law and the client base.

14 It is possible for the owners to take out life, TPD and trauma insurance, but to fail to enter into any agreement such as a succession plan. If, for example, the insurance is self-owned, then upon the principal's death or disability the outgoing owner receives the insurance proceeds. There is no legal requirement to treat that insurance as the deemed purchase price. It is then open for the

[51] If structured with the primary purpose of reducing taxation, then, while the transaction stands, the taxation benefits are lost. Part IVA is considered in Chapter Four.

outgoing owner to both take the insurance and then require the remaining owners to pay for the business interest.[52]

A second issue relates to a trauma event that may not affect the principal's ability to continue working in the business. For example, the principal may suffer a minor heart attack and be back at work a few days later with the trauma insurance proceeds. Without an agreement, the parties may dispute how the trauma proceeds are to be treated. They may be treated as a windfall for the principal, or treated as the payment of a deemed purchase price if the principal subsequently dies or is disabled.

The outcome of the principal's death or disability, from the above 14 points, may include litigation and business insolvency. There may also be a risk of bankruptcy of the principals, owners and family members. This is particularly the case if non-business assets, such as family homes, were used to secure loans and overdrafts for the business. The business may be the owners' main asset and its failure may cause a significant loss of income and a substantial reduction in the owners' overall wealth. From a wider perspective, the loss of the business may mean the loss of employment for staff and a loss to the economy.

The viability of an otherwise profitable small business may be threatened if a principal dies or is disabled. The consequences, as listed above, may be diminished if the parties establish an insurance-funded succession plan. The plan includes the remaining owners contractually agreeing to purchase the outgoing owner's interest in the business if the outgoing principal dies or is disabled. The remaining owners then continue to manage the business without 'interference' from the outgoing principal's family and heirs.[53] To achieve certainty of funding, death, TPD and trauma insurance policies can be purchased so that the payout matches the purchase price.[54] This would then 'relieve

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[52] This is further discussed in Chapter Six.

[53] Fishkind and Kautz, above n 15, 189.

[54] As stated in Chapter One, the research does not test whether other forms of finance are available or superior to insurance. Funding opportunities other than insurance include:

1 **Cash**: The remaining owners may not be holding, at the required time, ready cash reserves in savings or investments—particularly as death and disability are usually unexpected or accidental in nature. Such 'surplus' money may be more likely reinvested or moved out of the business for personal use or external investments.

2 **Sinking fund**: The owners can make regular payments to a savings account. Like holding cash, the strategy requires an appropriate amount of money sitting in reserve waiting for a principal's death or

liquidity problems by creating a market for the decedent's business interest'.[55] Insurance-funded succession planning provides certainty that upon the principal's death or disability funding is available. This has the immediate effect of removing the outgoing principal and outgoing owner from the business with full payment for the business interest. The outgoing owner receives, with certainty, the funds in a timely manner. The succession plan includes certainty as to the agreed purchase price for the outgoing owner's interest in the business. The parties can agree the value of the business each year or set out a formula or mechanism to value the business.

As set out in point 7 above, without a succession plan, even if the business can be valued, it may have no 'ready market'.[56] A succession plan 'creates a market for a shareholder's stock, reducing or eliminating the liquidity problems created by an estate's ownership of a block of closely held stock'.[57] As mentioned in point seven above, if there is no ready market to which to sell the interest at the desired price, a prudent executor, or outgoing owner, may seek greater involvement in the business to

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disability. Owners may hold the view that it is better to put such reserves to more productive (long-term) use within or outside the business. A sinking fund may not make commercial sense for some owners, especially where the money has already had tax paid on it. Further, it may take some time for a business to put aside sufficient moneys to purchase a sizeable interest in the business. Until such reserves are accumulated, the succession plan may have a deficit in the funding requirements. Sinking funds are rarely used in succession planning: See, Mark R High, 'Drafting Buy-Sell Provisions in Shareholder Agreements' (2010) 19 *Business Law Today* 5, 28.

3 **Borrow**: Owners can borrow money. However, lenders, especially for small businesses, may require security (such as the owners' family homes) and personal guarantees. Non-working spouses may be required to provide undertakings and collateral. The amount to be borrowed may be large in respect of the value of the business. As stated by US commentator High (Ibid., 30):

> Banks are also very reluctant to allow even healthy companies to take borrowed funds and send them upstream to reduce someone's equity position. They will talk about fraudulent conveyances, preference payments, and the like, but fundamentally, it just seems to violate a law of nature for them.

There may be an existing debt that is immediately repayable. The lender may see greater risk in the business now that a principal is no longer present.

4 **Vendor term finance**: Under vendor term finance (US equivalent of 'seller-financed buyout': see Ibid., 31), the outgoing owner receives the purchase price in instalments over an agreed period (for example, five years). The outgoing owner acts as the lender, with all the usual risks of a lender. This necessitates an ongoing relationship between the outgoing and the remaining owners. The outgoing owner may not receive the total amount payable, particularly if the business fails while payment is incomplete. The outgoing owner may wish to continue involvement with the business and seek security. Such security may breach existing credit obligations with the banks: see Ibid., 31. Under vendor finance, the remaining owners may liquidate the business and restart with another venture free of the debt. The business may already be in a weakened state with the loss of the principal, so it may not be difficult for the remaining owners to create a situation in which the business, as its current entity, is no longer viable.

[55] Zaritsky, above n 31, 1.02[2].

[56] Fishkind and Kautz, above n 15, 189; see also Ellentuck, above n 30, 1, where Ellentuck stated that a 'buy-sell agreement provides a market for those shares and liquidity for the deceased shareholder's estate'.

[57] Sam Strutt, 'Plans for Succession Can Reduce Family Feuds', *The Australian Financial Review*, 1 August 2001, 19.

protect and preserve the estate asset. This outcome may not be desired by the remaining owners.

D. The Value and Need for Succession Planning

As discussed in the above section, a principal's death or disability can affect adversely the viability of the small business. This is especially so if there is no insurance-funded succession plan. This section considers both the value of small businesses and insurance-funded succession plans. According to the Australian Bureau of Statistics, small business operators employ approximately 2.5 million people.[58] This is 38 per cent of the workforce.[59] The net taxation paid by small business operators in the 2006/2007 financial year was almost $12,000 million.[60]

There are approximately 2 million small business operators in Australia.[61] From June 2007 to June 2009, 314,009 of these operators 'exited'.[62] This is an exit rate of 15.8 per cent over the 2-year period, being an average exit rate of almost 8 per cent per financial year. However, not all of these exits 'necessarily equate to a business failure', as they include a sale of the business and changes to the business structure.[63]

While the above statistics are on 'exits', there are no statistics available on how many otherwise solvent and viable Australian small businesses fail because of the lack of succession planning (insurance-funded or otherwise).[64] Haswell and Holmes stated that:[65]

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[58] The term 'small business operators' is as defined by the Australian Bureau of Statistics, as set out and modified in Chapter One.

[59] This is excluding non-agricultural employees. This data is from the latest available statistics from the Australian Bureau of Statistics, *Small Business in Australia 2001* 1321.0, 9.

[60] Ibid. The latest available statistics are contained in 'Table 3.9: Company net tax, by company size (micro and small), 2006–07', 41 and 'Table 5.1: Partnerships, by size (micro and small), 2006–07', 61.

[61] Australian Bureau of Statistics, *Counts of Australian Businesses, including Entries and Exits, June 2007 to June 2009* 8165.0 (21 October 2010).

[62] The term 'exit' used by Ibid. is based on when a business 'ceases to remit GST for at least five consecutive quarters', 29.

[63] Australian Bureau of Statistics, above n 59, see 'Table 3.9: Company net tax, by company size (micro and small), 2006–07', 41 and 'Table 5.1: Partnerships, by size (micro and small), 2006–07', 61.

[64] Stephen Haswell and Scott Holmes, 'Estimating the Small Business Failure Rate: A Reappraisal' (1989) 27 *Journal of Small Business Management* 3; ABI/INFORM Global, 68–74, 68.

[65] Ibid.

> Researchers suggest that continued research, and greater academic resources be utilised in attempting to produce statistics to indicate the magnitude and timing of [small business] failures. In Australia, there are few attempts to make such assessments.

In contrast, statistics show that in the European Union approximately 30,000 owner-managed businesses, involving over 300,000 employees close each year through a lack of succession planning.[66]

In Australia, US and Canada 'studies have consistently found that [businesses fail predominantly] due to poor management'.[67] 'Poor management' may include the loss of a principal through death or disability where there is failure to plan for that loss. There are also no available statistics on how many small businesses have documented succession plans in Australia.[68] However, one commentator estimates that, in Australia, less than 30 per cent of business owners aged 51 to 60 have a written succession plan.[69]

There are, however, available statistics on 'family-owned businesses'.[70] According to the *Survey of Family Business Needs 2005*, while 57 per cent of family business owners intended to retire within the next 10 years (that is, by 2015), 68 per cent had not chosen a successor or an exit strategy. Thirty-four per cent did not have a documented succession plan.[71] This was the case even though 33 per cent intended to pass on the business to the next generation.[72] According to Strutt:[73]

> With the wealthy [Australian] baby boomer generation—those who built up wealth in the 1950s, 1960s and early 1970s—maturing, it is expected that about $600 billion of assets will be inherited in the next 10 to 15 years. … Latest statistics reveal that 60 per

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[66] Chris Martin, 'Adding the Intellectual "Spark" to Ownership Succession Planning' (Institute for Small Business Affairs, 23rd National Small Firms Policy & Research Conference, Aberdeen Knowledge Management Centre, 2000) 4.
[67] Peacock, above n 4, 8.
[68] Max S Smith, 'Are Family Firms Really that Different?: An Empirical Study of Some Managerial Differences between Family and Non-family SMEs when Industry and Size are Accounted for' (School of Commerce Research Paper Series: 05-06, 2005) 6.
[69] Ian S McEwan, 'Succession Planning for Small Law Firms' [2001] *Australian Legal Practice Management Journal* 30, 30.
[70] The term 'family-owned business' is defined in Chapter One.
[71] However, 54 per cent intend to develop a succession plan.
[72] 'Family Businesses Healthy, but Succession Planning Needs Attention' (Media Release, KPMG 22, August 2005).
[73] Sam Strutt, 'Plans for Succession Can Reduce Family Feuds', *The Australian Financial Review*, 1 August 2001, 19.

cent of family business owners have not reviewed their wealth recently and do not have a succession plan in writing.

For family-owned businesses, only a third continue into the second generation and less than a sixth survive after that generation.[74] The situation is similar in the US.[75]

Thirty-three per cent of non-family 'small business operators' were aged over 50.[76] While death, TPD and trauma are usually unforseen events, principals in this age group are generally at greater risk. However, as McEwan noted, younger principals are still susceptible to death or disability, with succession planning benefiting all age groups.[77] Bobbin summed it up as 'statistically, there is a 100 per cent certainty of death, what is not known is when'.[78]

Research conducted by the Australian Government suggests that most businesses do not fail within the 'first few years of their operation'; rather, most businesses 'survive for a considerable time'.[79] Until these statistics were released in 2000, it was believed by some commentators that most businesses fail in the first few years of their existence.[80] According to this government research, the 'majority of businesses that cease operation' include as a reason the death of a principal. This is 'unrelated to their financial position'.[81] It is open from the research to conclude that if small businesses do continue for a number of years, succession planning is important. It is important in helping a financially successful business to continue if there is a loss of a principal through death or disability. However, 'in measuring the level of small business failure, the results so

[74] McEwan, above n 69, 30.
[75] Researchers observe that only a small percentage of family firms survive the transition to the second generation and many intergenerational transitions fail soon after the second-generation takes control. See Alfredo De Massis, Jess H Chua and James J Chrisman, 'Factors Preventing Intra-Family Succession' *Family Law Institute* <http://fbr.sagepub.com>.
[76] Australian Bureau of Statistics, *Characteristics of Small Business, Australia (Re-issue)* 8127.0 (29 April 2005).
[77] McEwan, above n 69, 30.
[78] Peter Bobbin, *Successful Succession for Success* (Taxation Institute of Australia, 13th National Tax Intensive Retreat, 26 August 2004 and 2 December 2005) 3.
[79] Ian Bickerdyke, Ralph Lattimore and Alan Madge, *Business Failure and Change: An Australian Perspective* (Productivity Commission Staff Research Paper, 2000) XVIII.
[80] Amy E Knaup, 'Survival and Longevity in the Business Employment Dynamics Data' [2005] *Monthly Labor Review* 50, 51. For example, a study in the US found that from March 1998 to March 2002, regardless of the industry, 34 per cent of new small businesses failed within the first two years. Fifty-six per cent failed within four years.
[81] Bickerdyke, Lattimore and Madge, above n 79.

far have produced conflicting answers'.[82] More statistical research would be of benefit to isolate the reasons that small businesses fail in Australia.

E. Conclusion

This chapter has highlighted that there is potentially a high dependency by a small business on the principals who manage the business. Such dependency may be less in a larger business where the managers have no, or little, ownership in the business or where there is a larger hierarchy of managers and systems. The loss of a principal through death or disability can potentially damage an otherwise viable small business, leading to loss of employment and other adverse effects on the economy. The chapter has demonstrated the worth of small businesses to the economy. It is, therefore, important for the Government to consider, where necessary, reform and taxation relief to help support succession planning.

As Peacock has noted, 'poor management' is a 'consistent' reason for small business failures.[83] The government research suggests that small businesses continue for some time, yet few of these businesses have undertaken succession planning. Succession planning is, therefore, worthy of review to consider whether the taxation of the succession planning process optimises the taxation benchmark of business efficiency set out in Chapter One.

The next chapter considers the historical and definitional issues of insurance as used in succession planning and the historical development of succession planning. This is to understand better the effects of taxation legislation in later chapters.

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[82] Haswell and Holmes, above n 64, 69.
[83] Peacock, above n 4.

CHAPTER THREE: THE HISTORICAL DEVELOPMENTS OF INSURANCE AND SUCCESSION PLANNING

> 'When you buy health insurance, you are saying 'I bet I get sick' and the company is saying 'I bet you won't'. Just in case you do, however, the company is making the same bet with thousands of other people.'[1]

A. History and Definitions of Insurance in Business Succession Planning[2]

1 Introduction

As discussed in Chapter One, insurance provides certainty in business succession planning because the insurance proceeds provide the money to fund the purchase of an outgoing principal's business interest.[3] The three types of insurance used in succession planning are term life,[4] TPD and trauma (collectively 'insurance'). Before the 1950s, these three types of insurance were either relatively unknown or did not exist. This chapter considers the development of insurance for succession planning. A central issue to this research is how the ATO treats, and how the taxation legislation defines, 'life insurance'. To support the aim of whether the taxation laws need to be reformed, the historical definitions provide a basis for arguing that the legislation should define 'life insurance' differently to provide for a simpler and more equitable tax system, as tested against the taxation benchmarks set out in Chapter One.

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[1] RW Swagler, *Caveat Emptor! An Introductory Analysis of Consumer Problems* (1975) 3.

[2] For historic accounts of insurance see: Harold E Raynes, *A History of British Insurance* (Pitman, 2nd ed, 1964). The first edition was published in 1948; see also BE Supple, *The Royal Exchange Assurance. A History of British Insurance 1720–1970* (Cambridge, 1970).

[3] For the purpose of this research, 'insurance' incorporates the expression 'assurance'. The term 'assurance' is usually, but not exclusively, reserved for use for life insurance. However, in the past, the term referred to a product if a benefit was payable once the policy was carried out according to its terms. This distinction is now rarely accurate. See Australian Taxation Office, 'Taxation of Life Insurance Companies: Skilling Module 1', *Professional Development Program* (Canberra, 2003) 8. Endowment policies and whole of life policies, as discussed in the research, could be classified as life assurance policies, as the proceeds are not necessarily contingent upon the death of the life insured. However, there is judicial authority for the view that there is no legal distinction between the two expressions. See *Robertson v National Insurance Co of New Zealand* (1958) SASR 143, 149. Per Mayo J, the term 'assurance' is usually, but not exclusively, reserved for use in relation to life insurance.

[4] This term is considered later in this chapter.

2 The Three Traditional Forms of Life Insurance: Whole Of Life, Endowment and Term

Life insurance deals with death.[5] Upon the event of death, life insurance policies provide for a monetary amount to be paid to the estate, a person's dependants or some other party (such as the remaining owners of the business) named in the insurance policy.

Up until the 1950s, there were predominantly three types of life insurance in Australia: endowment, whole of life and term.[6] Endowment was payable when a person reached a certain age, or died before that age.[7] Whole of life was only payable on death.[8] In return for paying higher premiums, whole of life and

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[5] Life insurance often requires 'uncertainty' as to whether or when the insured event will occur and 'risk' in that the payout may be larger than the premiums received by the insurance company: see *Prudential Insurance Co v Inland Revenue Commissioners* (1904) 2 KB 658, 663; *Gould v Curtis* (1913) 3 KB 84, 91; *Department of Trade and Industry v St Christopher Motorists' Association Ltd* (1974) 1 All ER 395, 400; (1974) 1 WLR 99, 105; *Medical Defence Union Ltd v Department of Trade* (1979) 2 All ER 421, 424. However, Windeyer J in the *National Mutual* case stated [10], as to life insurance, 'it [death] is not a risk, it is a certainty; the only uncertainty is when it will occur'.

[6] *NM Superannuation Pty Ltd v Young* (1993) 41 FCR 182, 194; *National Mutual case* (1959) 102 CL 29, 43–45; *Jones v AMP Perpetual Trustee Co NZ Ltd* [1994] 1 NZLR 690 [1.11]. Also see Kenneth Sutton, *Insurance Law in Australia* (LBC Information Services, 3rd ed, 1999) 8. Endowment and whole of life policies were sometimes referred to as 'permanent' insurances. This is because if the person ceased to make payments of the premiums, they had a residual value. In contrast, with term life, TPD and trauma, all ongoing value in the insurance ceases at the end of the term, unless premiums for the next period are paid to the insurance company. See also ATO, *Income Tax: Capital Gains Tax: Is a 'Policy Of Insurance on the Life of an Individual' in Section 118-300 of the Income Tax Assessment Act 1997 Limited to a Life Insurance Policy within the Common Law Meaning of that Expression?* TD 2006/D36, note 1:

> A term policy is an insurance limited for a specified period, the sum insured being payable if the life insured dies within the period, but nothing being payable if he survives. A whole of life policy is one on which the sum insured is payable at death. An endowment policy provides for the payment of the sum insured at some future date called the maturity date or earlier death.

[7] Sutton, above n 6, 8 (Note: this is the latest edition).

[8] The previous definition of 'whole of life policy' in *ITAA 1936* s 267 was repealed as part of the Simpler Superannuation reforms by Act No. 15 of 2007 (on the earlier definition see ATO, *Income Tax—Complying Superannuation Fund: Deductibility of Premiums on 'Whole Of Life Policy'—Paragraph 279(1)(A) of the ITAA 1936*, ID 2009/99, 2 September 2009). The expression 'whole of life policy' is now defined as an insurance policy that satisfies the following conditions: *ITAA 1997* ss 295-485, 995-1(1):

- the policy includes an investment component
- the premiums are not dissected
- the sum insured (including any bonuses) is payable on the death of the individual insured, or on the earlier of:
  - the death of the life insured, or
  - the life insured reaching an age specified in the policy of 85 years or more.

Therefore, a policy can only be a whole of life policy where the premiums are not dissected between the investment and risk components of the policy. The only commentary currently available on the meaning of the expression is found in the ATO, *Income Tax—Complying Superannuation Fund: Deductibility of Premiums on 'Whole of Life Policy'—Subsection 295-465(1) of the ITAA 1997*, ID 2009/100, 28 August 2009. In that publication, the ATO examined a policy in which entry and exit fees were charged in addition to the annual policy premiums. The benefits payable on surrender of the policy were determined as the premiums received less fees charged on the policy (which included the entry fee), plus or minus the investment returns. The ATO stated that the policy was not a whole of life policy because the explicit identification of the entry fee showed that the premium had been dissected between an investment

endowment policies also provided a 'savings' component.[9] The 'savings' were available to pay the premiums if the premiums stopped being paid by the policyholder.[10]

In contrast, the third type of life insurance, being term life, had no savings component, so that the policy ceased when the premiums were no longer paid. However, the premiums were less expensive.[11] Scriven noted that whole of life and endowment policies 'declined in popularity as advisors educated their clients to insure with term and invest the rest'.[12] Since the 1980s, the insurance industry has seen the rise in popularity of term life insurance.[13] Whole of life and endowment policies are no longer widely offered in Australia and, therefore, are not considered in any detail in this research.[14]

'Life insurance' has been defined by both common law and legislation. These definitions are now considered.

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component and other components of the policy. Therefore, the policy did not meet the requirement in the definition that the premiums be undissected.

[9] Ed Diller, 'Whole Life Insurance or Term?' *Smart Money, The Wall Street Journal*, 29 September 2000; Doug Scriven, *Guide to Life Risk Protection and Planning* (CCH Australia, 2nd ed, 2008) 3.

[10] In acknowledgment of the savings component in whole of life and endowment polices, the Asprey Report grouped life insurance with superannuation and buying a house because 'they are the only common forms of contractual long-term savings in Australia'. Taxation Review Committee (Kenneth William Asprey, Chair), *Full Report* (AGPS, Canberra, 1975) ch 21[1].

[11] Scriven, above n 9, [1-030]; Nora Dunn, 'Universal Life Insurance and Whole Life Insurance: A Comparison' on Nora Dunn, *Wise Bread* (14 April 2009) <http://www.wisebread.com/universal-life-insurance-and-whole-life-insurance-a-comparison>; Anthony Steuer, *Questions and Answers on Life Insurance: The Life Insurance Toolbook* (iUniverse Star, 2007) 36.

[12] Scriven, above n 9, [1-030].

[13] See, Australian Taxation Office, above n 3; Raynes, above n 2. See also Mark J Brown and Kihong Kim, 'An International Analysis of Life Insurance Demand' (1993) 50 *Journal of the American Society of Chartered Life Underwriters*, 616, 624, in which, in their international study inclusive of Australia, the authors provide evidence that, when considering 'cost per dollar of life insurance coverage … price is negatively related to the insurance consumption'. For a contrasting view see Jeffrey R Brown, *Are the Elderly Really Over-Annuitized? New Evidence on Life Insurance and Bequests* (University of Chicago Press, National Bureau of Economic Research, January 2001). (Out of print but available at <http://www.nber.org/chapters/c10322.pdf>.)

[14] However, when compared to term insurance policies, whole of life insurance has the distinct advantage of having a residual value at a certain age. This may be useful in the funding of aged retirement in a succession plan.

3 Common Law Definition of 'Life Insurance'

An early definition of 'insurance' was given by Lawrence J in the UK case *Lucena v Crauford*.[15] His Honour stated that:

> Insurance is a contract by which one party in consideration of a price paid to him adequate to the risk becomes security to the other that he shall not suffer loss, damage, or prejudice by the happening of the perils specified to certain things which may be exposed to them.

The common law contract of 'life insurance' was considered by Bunyon:[16]

> The contract of insurance has been defined by Tindal CJ to be that on which a sum of money 'as a premium is paid in consideration of the insurer's incurring the risk of paying a larger sum upon a given contingency' (*Paterson v Powell*, 9 Bing, 329). The contract of life insurance may be further defined to be that on which one party agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum. ... This consideration in money is termed the premium or premiums, and is paid either in one sum, when it is termed a single premium, or by a succession of periodical instalments.[17]

This dictum has been cited with approval on several occasions, including by the High Court.[18]

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[15] (1806) 1 B&PNR 269, 301; also (1805) 127 Eng Rep 630. In some discussions of this case, especially in the US, 'Crauford' is sometime spelt as 'Crawford'.

[16] Charles John Bunyon, *Treatise upon the Law of Life Assurance: Upon the Constitution of Assurance Companies, the Construction of Their Deeds of Settlement, the Sale of Reversionary Interests, and Equitable Liens Arising in Connection with Life Policies* (T & JW Johnson, 1854) 17. This quotation has been cited numerous times by commentators and in cases, with approval, including in the recent case of *National Mutual Life Association of Australia Ltd v Commissioner of State Taxation* [2010] SASC 261 (25 August 2010) 2.

[17] The following cases cite *Paterson v Powell* with approval: *National Mutual Life Association of Australia Ltd v Commissioner of State Taxation* [2010] SASC 261; (2010) ATC 20-213, *Criterion Properties plc v Stratford UK Properties LLC* [2002] EWHC 868 (Comm); [2002] 2 All ER (Comm) 492; [2002] All ER (D) 280; [2003] 1 WLR 2108; [2003] 2 BCLC 129; [2002] Lloyds Rep IR 807; *Feasey v Sun Life Assurance Co of Canada* [2002] EWHC 868 (Commercial) (High Court of England and Wales).

[18] *Gould v Curtis* (1913) 3 KB 84, per Kennedy LJ, 97–98; *National Mutual Case* (1959) 102 CLR 29, per Windeyer J, 43; and as regards New Zealand, *Marac Life Assurance Ltd v Commissioner of Inland Revenue* (1986) 8 NZTC 5, 086.

In *National Mutual Life Association of Australasia Ltd v FCT* (‘*National Mutual*’), the insurance company bundled together life insurance with TPD.[19] The High Court held that, for the purposes of taxation legislation, TPD is not a life insurance policy.[20] This is the case even though the High Court acknowledged that TPD is issued by life insurance companies. Windeyer J held that the definition in Bunyon:[21]

> covers the three forms which, historically, life insurance has taken and which, singly or in combination, are the essence of a life insurance policy ... term policies, whole of life policies or endowment policies.

Therefore, under common law, TPD and trauma insurance (which did not exist at the time of the *National Mutual* case) are not included in the definition of ‘life insurance’. Over half a century later, the ATO continues to adopt this common law definition of life insurance for purposes that are considered in Chapter Six. Commentators have argued that the common law definition as considered by Bunyon and confirmed by the High Court is out of date and not in keeping with the advances in the creation of insurance products such as TPD and trauma.[22] This issue is developed in Chapter Six.

4 Statutory Definitions of ‘Life Insurance’

One of the earliest pieces of UK legislation in this area was the *Life Assurance Act 1774*.[23] This legislation also came to be applied in the Australian colonies.[24] In Australia, life insurance legislation was, until 1995, limited in its operation. The

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[19] (1959) 102 CLR 29.
[20] Under *ITAA 1936* s 111, a ‘life assurance company’ does not pay income tax on premiums paid for ‘life assurance’ policies. In this case, the insurance company received insurance premiums for a policy that contained both life insurance and TPD. The question was whether TPD came within the definition of ‘life assurance’. If it did not (which was the decision of the Court), then income tax was payable on that part of the premium relating to TPD.
[21] *National Mutual* Case (1959) 102 CLR 29, 43. The reasoning in this case has been followed recently in the South Australian stamp duty case of *National Mutual Life Association of Australia Ltd v Commissioner of State Taxation* [2010] SASC 261 (25 August).
[22] See, for example, Martin de Haas, *Discussion of Australian Taxation Office Draft Discussion Paper in Relation to Buy-Sell (Business Succession Planning Agreements)* (unpublished, Western Australia, 2004) 4.
[23] AC Gray, *Life Insurance in Australia, An Historical and Descriptive Account* (McCarron Bird, 1977) 1.
[24] The first Australian colony started on 26 January 1788 (now celebrated as Australia Day). See Alan Frost, ‘A Fit of Absence of Mind? The Decision to Colonise Botany Bay, 1779–1786’ in Alan Frost (ed), *Botany Bay Mirages: Illusions of Australia’s Convict Beginnings* (Melbourne University Press, 1994) 99.

introduction of the *Life Insurance Act 1995* (Cth) made extensive changes.[25] This is when compared to the *Life Insurance Act 1945* (Cth), which it replaced.[26]

The definition of 'life insurance' in the *Life Insurance Act 1995* is wider than the common law definition of 'life insurance'. 'Life insurance' is defined in the *Life Insurance Act 1995* section 9(1) to include:[27]

> a contract of insurance that provides for the payment of money on the death of a person ... or a contingency dependent on the termination or continuance of human life.

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[25] This was backed by greater legislative sanctions. Previously, much of the regulation was carried out by informal administrative rules that life companies complied with as a matter of industry agreement. The 1995 Act reduced the reliance on self-regulation. Some aspects of the self-regulation regime still exist in the form of life insurance disclosure circulars and codes of practice. However, the 1995 Act gives the Australian Prudential Regulation Authority (APRA) the power to make rules that are more formal. These form part of the statutory regime.

[26] Further reforms were made by the *Financial Services Reform Act 2001* (Cth), which came into effect generally from 11 March 2002, although there was a two-year 'phase-in' period ending on 10 March 2004. Those reforms are primarily contained in *Corporations Act 2001* (Cth) ch 7. That chapter, together with regulations made under the *Corporations Act 2001* (Cth), is designed to provide a comprehensive and integrated system for the regulation of the financial services industry. This includes life insurance products and organisations providing such products. The reforms made by the *Financial Services Reform Act 2001* (Cth) are relevant in particular to:

- the licensing and conduct of providers of life insurance products;
- the licensing and conduct of insurance intermediaries; and
- financial services and financial product disclosure to retail consumers of life insurance products.

A companion act, the *Financial Services Reform (Consequential Provisions) Act 2001* (Cth), repealed the *Insurance (Agents and Brokers) Act*. The provisions largely equivalent to that Act are now found in the *Corporations Act 2001* (Cth) ch 7.

[27] The *Life Insurance Act 1995* (Cth) contains an extended definition of 'life policy' in s 9 of the Act, as follows:

> (1) Subject to section (2), each of the following constitutes a life policy for the purposes of this Act:
>
> (a) a contract of insurance that provides for the payment of money on the death of a person or on the happening of a contingency dependent on the termination or continuance of human life;
>
> (b) a contract of insurance that is subject to payment of premiums for a term dependent on the termination or continuance of human life;
>
> (c) a contract of insurance that provides for the payment of an annuity for a term dependent on the continuance of human life;
>
> (d) a contract that provides for the payment of an annuity for a term not dependent on the continuance of human life but exceeding the term prescribed by the regulations for the purposes of this paragraph;
>
> (e) a continuous disability policy;
>
> (f) a contract (whether or not it is a contract of insurance) that constitutes an investment account contract;
>
> (g) a contract (whether or not it is a contract of insurance) that constitutes an investment linked contract.
>
> (2) A contract that provides for the payment of money on the death of a person is not a life policy if:
>
> (a) by the terms of the contract, the duration of the contract is to be not more than one year; and
>
> (b) payment is only to be made in the event of:
>
> (i) death by accident; or
>
> (ii) death resulting from a specified sickness.

The Full Court of the Supreme Court of South Australia considered this term in *National Mutual Life Association v Commissioner of State Taxation*.[28] In that case, the court noted that both the *Life Insurance Act 1995* and its predecessor, the *Life Insurance Act 1945*, linked life insurance policies to the happening of any 'contingency dependent on the termination or continuance of human life'.[29] The court held, in obiter dicta, that this 'distinguishes continuous disability policies' (such as TPD and trauma) from life insurance.[30]

A number of different contracts constitute a 'life policy' for the purposes of the *Life Insurance Act 1995*. For example, section 9(1)(e) includes a continuous disability policy that is non-cancellable and long-term.[31] This is defined in the Schedule of the *Life Insurance Act 1995* to mean a contract of insurance:[32]

> (a) that is, by its terms, to be of more than three years duration; and
>
> (b) under which a benefit is payable in the event of: (i) the death, by accident or by some other specified cause, of the insured, or (ii) injury to or disability of the insured as a result of accident or sickness, or (iii) the insured being found to have a specified condition or disease; and

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[28] [2011] SASCFC 106. This case considered the meaning of 'life insurance' under the *Stamp Duties Act 1923* (SA), which prescribed lower rates of duty payable on premiums 'relating to life insurance' and higher rates on premiums 'relating to policies of any kind (other than life insurance policies)', such as TPD and trauma. The Full Court of the South Australian Supreme Court affirmed the decision at first instance, finding that the duty on the 'rider' policy to the life insurance policy is payable at the higher rate applicable to general insurance. As to this question see *Pass v Gerling Australia Insurance Company Pty Ltd* [2011] WASCA 93, where that case considered personal injury and whether the death of the deceased was an injury as defined in the insurance policy. See also *Norwich Union Life Australia Limited v Commissioner of State Revenue* [2011] WASAT 149. However, compare these to the Western Australia State Administrative Tribunal, which allowed a taxpayer's objection to an assessment of duty in relation to life, critical illness and income protection policies of insurance.

[29] 'Life policy' was defined in the *Life Insurance Act 1945* (Cth) s 4(1) as:

> a policy insuring payment of money on death (not being death by accident or specified sickness only) or on the happening of any contingency dependent on the termination or continuance of human life (either with or without provision for a benefit under a continuous disability insurance contract), and includes an instrument evidencing a contract which is subject to payment of premiums for a term dependent on the termination or continuance of human life and an instrument securing the grant of an annuity for a term dependent upon human life.

[30] *National Mutual Life Associate v Commissioner of State Taxation* [2011] SASCFC 106, 30 September 2011 [31].

[31] *Life Insurance Act 1995* s 9(1)(e).

[32] It does not include a contract of consumer credit insurance under the *Insurance Contracts Act 1984*. See *Life Insurance Act 1995* s 9(1)(e).

(c) the terms of which do not permit alteration, at the instance of the life company concerned, of both the benefits provided for by the contract and the premiums payable under the contract.

The *Insurance Contracts Act 1984* (Cth) section 11(1) defines a 'contract of life insurance' as a contract that constitutes a life policy within the meaning of the *Life Insurance Act 1995*.[33] A 'continuous disability insurance policy' means a contract that is a continuous disability policy within the meaning of the *Life Insurance Act.* The term 'life insurance', therefore, also includes disability insurances such as TPD and trauma under the *Life Insurance Act*. This contrasts to the more limited common law definition of 'life insurance', as discussed above. The effect of the two different definitions is considered in respect of the taxation legislation in Chapters Five and Six.

From the above examination of life insurance, term life, TPD and trauma insurances can now be considered.

5 Term Life Insurance

As discussed above, term life insurance (life insurance) is insurance payable only upon death during a 'specified period' during the life of the policy (while the premiums are paid). Such insurance policies have operated within Australia for many years.[34] They have been regulated under Australian legislation since 1864.[35] Insurance policies are given a broad definition under section 9 of the *Life Insurance Act 1995* (Cth). They are any one of seven different types of policies.[36] Such policies may be used to provide

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[33] All insurance transactions from 1 January 1986 are pursuant to this Act.

[34] For an understanding of common law and notion of 'precedent', see Washington Probate, 'Estate Planning & Probate Glossary' (Washington (State) Probate, 8 December 2008) s.v. 'common law'.

[35] UK legislation that became applicable to the Australian colonies dates back to 1774 (*Life Assurance Act 1774*). However, for specific Australian legislation that replaced that Act, see for example, *Instruments and Securities Act 1864* (Vic); *Life Assurance Companies Act 1889* (WA); *Insurance Act 1902* (NSW); *Imperial Acts Application Act 1969* (NSW); *Life Insurance Act 1995* (Cth).

[36] *Life Insurance Act 1995* (Cth) s 9:

(1) Subject to section (2), each of the following constitutes a life policy for the purposes of this Act:

(a) a contract of insurance that provides for the payment of money on the death of a person or on the happening of a contingency dependent on the termination or continuance of human life;

(b) a contract of insurance that is subject to payment of premiums for a term dependent on the termination or continuance of human life;

(c) a contract of insurance that provides for the payment of an annuity for a term dependent on the continuance of human life;

(d) a contract that provides for the payment of an annuity for a term not dependent on the continuance of human life but exceeding the term prescribed by the regulations for the purposes of this paragraph;

funds to the deceased's spouse and dependants. The proceeds are sometimes considered to be replacing the income and security that was previously provided by the deceased.[37] From this perspective, the proceeds are applied, theoretically, for the dependants' ongoing benefit.[38] Although developed for these familial uses, the same insurance products are now commonly applied for succession planning purposes.[39]

Prior to 1 July 1995, the owner of an insurance policy needed 'good reason' to hold an insurance policy over another person's life.[40] Under the *Insurance Contracts Act 1984* section 19, such policies were void if there was no justifiable reason for holding the insurance.[41] While a person had an insurable interest in her or his own life, they could not take out life insurance on another person unless there was a pecuniary interest.[42] The pecuniary interest, such as an obligation to pay the insured person's funeral, would not suffice.[43] This was a potential impediment for the use of insurance as between the non-related owners and their business structures. For example, the succession planning insurance can be cross-owned whereby, upon the principal's death, the remaining owners receive the insurance proceeds. In that instance, the remaining owners, while having an obligation to use the proceeds to purchase the outgoing owner's business interest, do not suffer pecuniary loss. The principal's death may not have been an insurable interest in those circumstances.

(e) a continuous disability policy;
(f) a contract (whether or not it is a contract of insurance) that constitutes an investment account contract;
(g) a contract (whether or not it is a contract of insurance) that constitutes an investment-linked contract.

[37] Brown and Kim, above n 13, 617; see also B Douglas Bernheim, 'How Strong are Bequest Motives? Evidence Based on Estimates of the Demand for Life Insurance and Annuities' [1991] *Journal of Political Economy*, 899–927.

[38] Brown and Kim, above n 13.

[39] Ian S McEwan, 'Succession Planning for Small Law Firms' [2001] *Australian Legal Practice Management Journal* 30, 30.

[40] This is often referred to as an 'insurable interest'. The first legislation that applied to the Australian colonies to prohibit insurance contracts with no insurable interest was the *Life Assurance Act 1774* (UK).

[41] The restriction was intended to remove the incentive for policy owners to deliberately harm the life insured and recoup the policy proceeds. For commentary on the US equivalent, see Sharon Murphy, 'How to Make a Dead Man: Murder, Fraud and Life Insurance in 19th-century America' (2010) 97 *Financial History* 28. A US example is *Liberty National Life v Weldon*, 267 Ala 171 (1957), where a person with no insurable interest took out life insurance and then murdered the person insured for the life insurance proceeds.

[42] Sutton, above n 6, 523, citing as authority *Wainright v Bland* (1835) 1 Moo & R 481.

[43] *Southern Cross Assurance Co Ltd v Australian Provincial Assurance Association Ltd* (1935) 53 CLR 618, 635.

This restriction was removed by the *Life Insurance Act 1995* (Cth).[44] The change in the legislation increased the flexibility in succession planning structures, as other entities could own the insurance on the principal without needing justification.[45]

6 Total and Permanent Disability Insurance

The second type of insurance is TPD insurance. This provides cover against losses resulting from injury or illness.[46] TPD was introduced into Australia in the 1950s.[47] To receive the proceeds under a TPD policy, the insured party must be rendered unable to work for reward or to engage in any major duties of employment. This may be in their particular profession or usual area of work. A typical definition of TPD is 'an inability to work for reward or perform any of the major duties of a specified occupation'.[48] Definitions vary depending on the insurance provider. In the context of succession planning and for the purposes of this research, the insured party is the principal, who suffers a disability, short of death, that renders that principal unable to continue functioning in the role of principal in the business.

In a typical TPD insurance policy, the key terms 'total', 'permanent' and 'disability' are exhaustively defined.[49] While definitions vary between different insurance providers,

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[44] The restrictions were also removed from the *Insurance Contracts Act 1984* in 1993 pursuant to Act No. 36 of 2003, where s 18 states:

> 18 Insurable interest not required
> (1) This section applies to:
> (a) a contract of life insurance; or
> (b) a contract that provides for the payment of money on the death of a person by sickness or accident.
> (2) A contract to which this section applies is not void by reason only that the insured did not have, at the time when the contract was entered into, an interest in the subject-matter of the contract.

[45] The different ways of owning the insurance are considered in Chapter Six.

[46] TPD policies may be worded to provide benefits only in the case of 'injury' or only in the case of 'illness'. These are separate concepts. Alternatively, different payout amounts may apply for either circumstance. Such distinctions generally do not concern owners in the context of a succession plan, as the payout amount is governed by the value of an owner's interest in the business, not the qualitative aspect of the insurable event. For succession planning, a TPD insurable event must simply render a principal unable to continue in their position within the business.

[47] Scriven, above n 9, [1-010].

[48] David Kelly and Michael Ball, *Principles of Insurance Law* (LexisNexis) 13.0100.5, <http://www.lexisnexis.com/audelivery/legal.htm>; ATO, *Income Tax: Deductibility Under Subsection 295-465(1) of the Income Tax Assessment Act 1997 of Premiums Paid by a Complying Superannuation Fund for an Insurance Policy Providing Total and Permanent Disability Cover in Respect of its Members*, TR 2010/D9, para 53 gives an example of own occupation TPD policy as:

> (a) as a result of accident or injury, the insured is completely unable to work at their own occupation continuously for a period of at least 4 months and after considering medical and other evidence are unlikely ever to be able to do so again.
> (b) own occupation means the occupation the insured was engaged in at the time of the insured application for this insurance.

[49] Issues and disputes over the above definitions generally only occur between insurers and policy owners, rather than between owners. In succession planning, the owners must agree and understand the

for the purposes of succession planning in this research, total disability is the inability to continue in the role of principal.[50]

A factor differentiating TPD from trauma insurance is the permanence of the condition suffered. Trauma has no requirement of permanence. The three requirements that must be satisfied for the TPD condition to be considered permanent are:[51]

1. the person insured is unable, for a continuous period of 6 months, to work at their occupation as a result of an accident or illness;

2. at the end of that period, the insured's disablement is beyond hope of improvement, or the insurer is satisfied that the disablement is permanent; and

3. the disablement prevents the insured from working ever again in that occupation or another defined occupation.

TPD policies are generally less expensive because they are harder to claim against when compared to trauma insurance. Trauma insurance is now considered.

7 Trauma Insurance

Life insurance provides money following the death of the policyholder. TPD insurance provides money when the policyholder can no longer work.[52] Trauma insurance

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agreement on the policy terms among themselves. This avoids problems such as the expectation by an outgoing owner of an immediate payout where none may be forthcoming. For example, if the TPD event is for some reason uninsured, the remaining owners must resort to some other way of funding the purchase of the outgoing owner's interest in the business, other than insurance.

[50] The exact meaning of 'total' has been the cause of some dispute. See for example, *In Ibrahim v Greater Pacific Life Insurance Co* (1996) 9 ANZ Ins Cas 61, relating to the life insured suffering from a disability. The insurer ceased payments after several months, arguing that the insured was no longer entitled to payments under the policy, as the disability was not 'total' as defined in the policy. The life insured, a diamond setter, was, in fact, capable of performing some of the relevant duties, but only for very short periods. The NSW Supreme Court rejected the insurer's argument, stating 'I do not think that [the definition] means that an ability to work for half an hour a day at one of the major parts of his regular occupation, which seems to be about his limit, produces the result that he was not totally disabled', 63.

[51] This list is adapted and paraphrased from Kelly and Ball, above n 48.

[52] That is, when they have one of the defined critical illness events as set out in the relevant insurance company's Product Disclosure Statement. Unlike in the UK (see Sara Rich, 'The Advantages of a United Approach', *Money Management*, 19 March 2007 <http://www.moneymanagement.com.au/news/The-advantages-of-a-united-approach>), there is no universal or legislated definition of the critical illnesses in Australia. Instead, each insurance company provides their own definition for the purposes of what they

provides money when the policyholder becomes ill but, often with medical assistance, continues to live.[53] Trauma insurance is also known as 'critical illness insurance'.[54] Trauma insurance pays a lump sum upon medical diagnosis of a defined condition or disease as exhaustively set out in the relevant insurance policy.

The development of trauma insurance is directly credited to Dr Marius Barnard.[55] Dr Christian Barnard, the brother of Marius, headed the team of the world's first successful heart transplant in South Africa in 1967. Dr Marius Barnard assisted in that operation. He observed that organ transplants helped patients survive serious illness, but that such patients were left financially destitute because of treatment costs.[56] Dr Marius Barnard is quoted as saying, 'they didn't lose their life, they lost their life savings'.[57] He proposed a solution to the problem in the form of a type of insurance that provided a lump sum payment to the patient when the insured event was diagnosed. This allowed the patient to pay immediate treatment costs as well as living costs after recuperation.[58]

The outcome of his suggestion was that South Africa created the world's first trauma insurance policy in 1983.[59] Today, trauma insurance is available in most countries, including Australia.[60] Trauma proceeds are paid if a principal suffers, during the period of insurance, any one of a defined list of illnesses or injuries, such as a stroke or heart attack.[61] Diseases such as cancer, Alzheimer's disease and Multiple Sclerosis are included.[62] Non-pathological physical events such as blindness, loss of limbs or severe

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cover in their trauma insurance policy. See also Marius Barnard, *Critical Illness Insurance: Past, Present and Future*, <http://www.actuaries.org.uk/sites/all/files/documents/pdf/Barnard.pdf>.

[53] Barnard, above n 52.

[54] Outside Australia, the term 'critical injury' is often used instead of 'trauma'. See AR Fantini, RA Esperti and RL Peterson, *Love, Money, Control: Reinventing Estate Planning* (Esperti Peterson Institute, 2004). As to the usage in Australia, see Sara Rich, above n 52.

[55] Barnard, above n 52.

[56] *Health Insurance Monitor*, May 1995; also cited in *Health Insurance*, 1996, 78.

[57] Dr Marius Barnard, May 1997, stated that his patients 'didn't lose their life, they lost their life savings' after surviving fatal illnesses such as cancer, stroke or heart disease. He also stated that 'you need insurance not because you are going to die, but because you are going to live. [Today, individuals] have a greater chance of living long enough to become seriously ill', Barnard, above n 52.

[58] Ibid.

[59] A Rickard, 'Condition Critical' *CMA Management* (March 2003), http://www.managementmag.com/index.cfm/ci_id/1679/la_id/1.htm, 23.

[60] Ibid.

[61] The list, as defined by each insurance company, forms part of the policy terms and is usually exhaustive and exclusive. It may specify 50 or more illnesses and injuries.

[62] As with TPD, the ATO stated that it does not draw a distinction between a specified 'illness' and an 'injury' in regard to the tax treatment of trauma policies: see ATO, *Income Tax: Capital Gains: Is a Sum Obtained by a Taxpayer Under a Trauma Insurance Policy an Exempt Capital Gain Under Subsection 160ZB(1) of the Income Tax Assessment Act 1936?* TD 95/43, 9 August 1995. The determination deals with exemptions from CGT for Trauma policies.

burns are often included.[63] The policy usually also covers defined operations and treatments.[64]

A key difference between trauma and TPD insurance is the longevity and duration of the after-effects of suffering the insurable event. Depending on the event, there may be little to separate a trauma and TPD event medically. However, the practical and contractual distinctions can be substantial when they are used as a funding mechanism in a succession plan. By definition, a principal who suffers a TPD event is generally forced by the disability to leave their position of employment immediately and permanently. In contrast, it is possible for a principal suffering a trauma event to continue working. The principal may continue working indefinitely and at full capacity. For example, the trauma event may entail the diagnosis of cancer, but the principal may be in otherwise good health and remain fully functioning in the capacity of principal. Likewise, a principal may recover from a trauma event and return to work in due course. For example, the cancer may be treated successfully or go into remission.[65]

8 Conclusion as to History of Succession Planning Insurance

With the popularity of the less expensive term life insurance from the 1980s, the funding of the succession plan using term life insurance became more affordable.[66] This allowed more succession plans to be funded using life insurance.[67] In the 1950s, TPD was introduced into Australia. This allowed principals to be insured for disability events that prevented them working as a principal. In the 1990s, trauma insurance became available in Australia. This gave further funding opportunities when a principal suffered from a disability that, often due to medical advances, did not necessarily cause death.

This part of the chapter has considered the definition of life insurance under both common law and Commonwealth legislation. There are tax benefits attached to life

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[63] See for example, Suncorp Recovery Protect, 'Product Disclosure Statement' (2009) <http://www.suncorp.com.au/sites/default/files/suncorp/personal/life_insurance/pdf/suncorp_recovery_protect_pds.pdf>.

[64] Kelly and Ball, above n 48.

[65] Under such circumstances, where the principal continues to act in that capacity, complex organisational issues, as well as taxation and administrative issues may arise. It is open for a succession plan to provide for such eventualities. However, as stated in Chapter One, the research is limited in scope to where the principal suffers a trauma event and, because of that event, no longer works in the business.

[66] Kelly and Ball, above n 48.

[67] See note regarding the concept that, as the cost of the insurance decreases, the more likely it is that more insurance will be purchased.

insurance. However, by relying on the common law definition of 'life insurance', the ATO takes the view that TPD and trauma do not come within the definition of 'life insurance'. The ATO's approach and publications rely heavily on the *National Mutual* case.[68] However, at the time the case was heard, term life insurance was, according to Windeyer J who gave the majority judgment, 'very rare', TPD was not yet popular and trauma insurance did not exist.[69] Further, in that case, 'whole of life' was considered 'life insurance', even though it had a savings component that was not contingent upon loss of life, while TPD was not considered 'life insurance'. Finally, Windeyer J stated that as to previous judicial authority as to the meaning of life insurance, the definition was not a 'comprehensive definition; it was probably not intended to be; it certainly is not today. It was a description of the usual form of the whole of life policy'.[70] Further, as Gray J recently stated:[71]

> Before turning to consider the meaning of the words 'life insurance' for the purposes of the *Stamp Duties Act* [1923 SA], it is appropriate to make one further observation. With the passage of time, the meaning and scope of words may change. For a document which operates only for a short period following its creation, this presents little difficulty. However, the same cannot be said about the interpretation of legislation which often goes many decades without updating, the impugned words often having in that time changed in scope, denotation and connotation.

These factors leave open the prospect that, should the High Court consider the matter again, the decision of the minority judgment by Taylor J in the *National Mutual* case may be followed.[72] If that were the case, then TPD, and possibly trauma, insurance might fall within the definition of 'life insurance' with the associated tax benefits that are set out in Chapter Six.

Australian commentators have considered many of these issues and, to provide context, the historic academic literature on succession planning is considered in Chapter Four.

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[68] See for example ATO, *Income Tax—Capital Gains Tax: Exemptions—Proceeds of Continuous Disability Policies*, ID 2004/313, 31 March 2004 (withdrawn) and ATO, *Income Tax: Capital Gains Tax: Is a 'Policy Of Insurance on the Life of an Individual' in Section 118-300 of the Income Tax Assessment Act 1997 Limited to a Life Insurance Policy within the Common Law Meaning of that Expression?* TD 2006/D36.

[69] *National Mutual Case* (1959) 102 CLR 29, 43.

[70] Ibid.

[71] *National Mutual Life Association v Commissioner of State Taxation* [2011] SASCFC 106 [109] (Full Supreme Court of South Australia).

[72] *National Mutual Case* (1959) 102 CLR 29.

B. Historical Context of Succession Planning

> 'The death of one of several participants may result in a substantial loss of the enterprise as a whole and to the family of the decedent. After the death of one of the principal managers, the family will no longer have the advantage of the decedent's earning ability ... it will be advantageous for the ... remaining owners to buy out the interest of the decedent ... obviously life insurance is exactly what is needed.'[73]

1 Introduction

To provide an historical context, this part of the chapter explores the academic literature on succession planning in small businesses, primarily where a principal leaves the business because of death or disability.[74] The Australian literature reveals that, with the introduction of CGT, there has been no agreed method on how to structure the succession plan. The traditional methods of structuring the plan and holding the insurance, because of ambiguity and uncertainty in the taxation legislation, have given way to new approaches. In contrast, in the US, where succession planning is firmly established, there is agreement between the commentators as to the operation of the taxation laws. In the US, there is a need for only two ways of structuring the succession plan. Both are tax effective and the taxation laws are relatively certain and unambiguous. The historical development demonstrates that the Australian taxation system, as it relates to succession planning, is not consistent with the taxation benchmarks.[75]

Other jurisdictions are also considered, where appropriate, to provide context for the Australian situation. Most of the literature, especially the early literature, derives from the US. The historical review shows that succession planning had the greatest development in the US, where there has been a reasonably consistent and clearly stated approach to the taxation of succession planning.[76]

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[73] Ralph R Neuhoff, 'Life Insurance Funding of Business Buy-Out Agreements' (1960) 25 *Missouri Law Review* 3.
[74] 'Disability' and 'disabled' are defined in Chapter One as resulting from a trauma or TPD event in which the outgoing principal is no longer able to work in the business.
[75] The taxation benchmark is established in Chapter One.
[76] After compiling the research, the publications were filtered for a focus on small businesses using insurance to fund the succession plan of the outgoing owner's interest. An emphasis was placed on the

The value of this review and its uniqueness is that it amalgamates the available evidence and offers a detailed insight into the development of succession planning in Australia with a comparative study using the US. The chapter considers the early literature. The use and importance of succession planning and insurance is evaluated. The chapter concludes by offering a comparison to the US system, in which commentators are generally in agreement with the taxation aspects and mode of carrying out a succession plan. This provides juxtaposition to the lack of agreement in Australia.

2 Succession Planning in the Early Literature

Business owners wanting to protect themselves when their business partner dies or is disabled is not a new concept. Ip and Jacobs stated that the desire for succession planning lies far back in the roots of 'anthropology and the study of kinship'.[77] Laikin argued that 'businessmen must plan for death as well as for life'.[78] Zaritsky noted that the process of succession planning has a long history in the US.[79]

The early works emphasise succession planning for large businesses without the use of or need for insurance.[80] Since the 1950s and 1960s, in the US, there has been an increase in the number of works regarding succession planning for the small business. In 1968, the literature stated that the specific pursuit of succession planning for small businesses using a documented succession agreement grew in

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taxation aspects of succession planning. All relevant information resulting from the search was reviewed. Articles that provided the same information, where relevant, are mentioned in the footnotes.

[77] Barry Ip and Gabriel Jacobs, 'Business Succession Planning: A Review of the Evidence' (2006) 13 *Journal of Small Business and Enterprise Development* (UK) 3, 326, 326, citing Robin Fox, *Kinship and Marriage: An Anthropological Perspective* (Penguin, 1967) 16–17; Robin Fox, *Reproduction and Succession: Studies in Anthropology, Law, and Society* (Transaction Publishers, 1993); Meyer Fortes, *Kinship and the Social Order* (Routledge and Kegan Paul, 1970) 305; R Parkin, *Kinship: An Introduction to Basic Concepts* (Blackwell, 1997) 22–23, 127, cited with approval by Australian commentator Bill Hovey, 'Succession—It's More than You Might Think', *Linchpin Succession Management* (March 2008) <http://www.linchpingroupaustralia.com/files/files/Succession_Its%20More%20than%20you%20Think.pdfstating> 6.

[78] George J Laikin, *Survivor Purchase Agreements and Taxes* (1958) ABA Sec Real Prop, Prob and TrPoc, 13–29. 13.

[79] Howard M Zaritsky, *Structuring Buy-Sell Agreements* (Warren, Gorham & Lamont, 2nd ed, 2000) 42.

[80] See, for example, one of the earliest works on succession planning, being Henri Fayol, 'L'exposé des principles généraux d'adminstration' (unpublished, 1908, translated by JD Breeze), cited in Bill Hovey, above n 77, 5 and also cited in DA Wren, AG Bedeian and JD Breeze, 'The Foundations of Henri Fayol's Administrative Theory' (2002) 40 *Management Decision* 9; ABI/INFORM Global, 906. See also one of the oldest books on succession planning, being Walter Robert Mahler and William F Wrightnour, *Executive Continuity* (Wrightnour, 1973), where Mahler and Wrightnour concentrate on succession planning for larger businesses, including for General Electric.

popularity in the US.[81] From this time, the literature in the US becomes more consistent in how to structure succession planning and the taxation issues.[82]

In the US, Jackson stated that it is common to form an agreement for the remaining owners to buy out the principal who dies.[83] He further stated that:[84]

> But it may be advisable to go beyond this if there is a likelihood that the partnership will be without sufficient cash funds at a partner's death to effect such a settlement. ... it may be feasible to set up a reserve fund or to effect life insurance policies on the partners' lives, the proceeds to be used to pay for the deceased's share of the business.

Another US paper, by Laikin and Lichter, stated:[85]

> A survivor-purchase agreement obligates the estate of the decedent to sell and the survivors to purchase the business interest at death. It is valid and enforceable. The mutual promises of the parties constitute adequate consideration. It is not testamentary in character ... Where life insurance is used to provide funds, such instruments are sometimes called 'business insurance agreements'.[86]

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[81] Ibid.

[82] C Roland Christensen, *Management Succession in Small and Growing Enterprises* (Harvard Business School Press, 1953). Christensen's book is primarily concerned with management succession and grooming new leaders to take control, rather than with a change of ownership. See also, Alvin W Gouldner, *Patterns of Industrial Bureaucracy: Case Study of Modern Factory Administration* (Collier-Mac, 1954); Donald B Trow, 'Executive Succession in Small Companies' (1961) 6 *Administrative Science Quarterly* 2, 228–39. Trow primarily examines succession planning as it relates to families. See also, Robert H Guest, 'Managerial Succession in Complex Organizations' (1962) 68 *The American Journal of Sociology* 1, 47–56.

[83] Edwin F Jackson, 'Federal Tax Aspects of Partnership "Survival Insurance" Arrangements' (1949–1950) 4 *Arkansas Law Review* 187, 187–197.

[84] Ibid., 188.

[85] George J Laikin and LR Lichter 'Tax Aspects of Survivor-Purchase Agreements' [1948] *Wisconsin Law Review* 139, 140. See also Laikin, above n 78, 14.

[86] See Laikin and Lichter, above n 85, as to its validity and enforceability, citing in their fn 139 the following authorities:

> *Kavanaugh v Johnson*, 290 Mass. 587, 195 N.E. 797 (1935); *Rankin v Newman*, 114 Cal 635, 46 Pac 742 (1896); *Casey v Hurley*, 112 Conn 526, 152 Atl. 892 (1931); *Re Rohrbacher's Estate*, 168 Pa. 158, 32 Atl. 30 (1895) [reversing 14 P Co Ct 568, 3 Pa Dis 264 (1895)]; *Re Eddy's Estate*, 175 Misc. 1011, 26 NYS 2d 115, (1941); *See also* 40 Am. Jur § 311; Notes and cases 73 ALR 983; Forster, *Legal, Tax and Practical Problems under Partnership Purchase and Sale Agreement*, 19 So Cal Law Review 1 (1945).

Commentators have stated that succession planning provides a 'ready market' for an otherwise illiquid asset.[87] This is for a 'fair price' when a principal dies or is disabled.[88]

3 The Use and Value of Insurance

While the tradition of succession planning has a long history in the US, using insurance to fund the buy-out is not as matured. Literature relating not just to succession planning, but also to the use of insurance to fund the succession plan, dates back only to the 1940s.[89] For example, Darling states that:[90]

> If we assume that the partners desire to bind the survivor to purchase the interest of a deceased partner, the problem on how to fund the agreement becomes vital. The higher values which a partner hopes to assure for his estate in the event of his death obviously will not be assured if there is no reasonably reliable source of payment for the deceased partner's interest. Life insurance on each partner is an obvious way of obtaining funds on death, and has done much to stimulate the formation of buy and sell agreements.

As to the benefits of using insurance to fund the purchase of the outgoing owner's interest in the business, Laikin and Lichter stated that:[91]

> Many businessmen take advantage of life insurance as a means of economically and efficiently providing ready cash wherewith to purchase a decedent's business interest. That an insurable interest is present is beyond question. However, the tax aspects of such insurance arrangements require careful consideration.

In the US, Dr Anthony Fantini's book *Love, Money, Control: Reinventing Estate Planning*, stated:[92]

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[87] Ibid., 140.
[88] Ibid.
[89] RH Forster, 'Legal, Tax and Practical Problems under Partnership Purchase and Sale Agreements' (1945) 19 *Southern California Law Review* 1.
[90] SR Darling, 'Buy and Sell Provisions of Partnership Agreements' (1949) 29 *Oregon Law Review* 286, 295.
[91] Laikin and Lichter above n 85, 154.

> In an increasing number of cases, life insurance is used to fund a buy-sell agreement because it can be effective in almost any type of buy-sell arrangement. It funds the buyout at the death of an owner by providing cash to the deceased owner's family to implement the buyout.[93]

Ip and Jacobs, in their UK literature review, cite a number of early publications on succession planning.[94] All of these publications are from the US. They reviewed no earlier publication in any other country, including the UK.[95] However, US commentator Fahr refers to the 1905 UK book, *The Case of Partnership Assurance*, by Wansbough.[96] Fahr quotes from Wansbough regarding the use of insurance between business owners to fund a succession plan as a 'system ... in vogue for many years'.[97]

4 Events that Trigger the Agreement

The happening of an 'event', set out in the agreement, triggers the succession plan so that the remaining owners have the right to buy the outgoing owner's interest in the business. Such events can be insurable and non-insurable. As examined in this chapter, the insurances available are life, TPD and trauma. As to non-insurable events, commentators have suggested that 'typical [non-insurable] events'[98] include:

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[92] Fantini, Esperti and Peterson, above n 54. Similar comments have been made by other US commentators such as Forster, above n 89, 1; George R Currie, *Buy and Sell Agreements with Respect to Corporate and Partnership Interests* [1950] *Wisconsin Law Review* 12, 19; Martin I Blaustein, 'Buy-Sell Agreements: Use of Life Insurance' [1988] 58 *The CPA Journal* 11, 100–101; Zaritsky, above n 79, where at 8-3, Zaritsky stated that 'Life insurance is often the preferred means of funding … [and] is the most common way to finance the purchase of a business interest at the death of the owner'.

[93] Zaritsky, above n 79, 385. In Australia, it is now so commonplace to use insurance as a funding mechanism that Paul Hockridge, *Succession Planning Masterclass—Business Succession—Demystifying Buy-Sell Agreements* (Taxation Institute of Australia, 2010) 4 suggests that the use of insurance is 'assumed'. See also Peter Bobbin, *Successful Succession for Success* (Taxation Institute of Australia, 13th National Tax Intensive Retreat, 26 August 2004 and 2 December 2005); Peter White and Ian MacPherson, *Business Succession Planning Buy/Sell Agreements* (Taxation Institute of Australia, 20 September 2006) 9, 11; and David Turnbull, *Business Succession Planning for Shareholders, Unitholders and Partners* (Taxation Institute of Australia, SMS Tax Intensive, Victoria, 29 May 2001), where Turnbull discusses 'alternatives' to using insurance.

[94] Ip and Jacobs, above n 77.

[95] Ibid., 326.

[96] Samuel M Fahr, 'The Business Purchase Agreement and Life Insurance' (1950) 15 *Law and Contemporary Problems* 321, where at fn 24, Fahr stated that, in respect of Wansbrough, 'Many of the most pressing problems of today are dealt with by this author', citing TP Wansbrough, *The Case for Partnership Assurance: An Opinion on the Question of the Legal Insurable Interest of Partners in the Lives of Each Other* (London, 1905).

[97] Fahr, above n 96, 321.

[98] Ibid.

retirement; resignation;[99] 'principal winding down their active involvement in the business';[100] bankruptcy;[101] loss of licence, practicing certificate or 'ticket' to conduct a business; conviction of a serious criminal offence; divorce;[102] criminal conviction and 'unacceptable performance'.[103]

In the succession planning agreement, Hockridge, while acknowledging the value of dealing with non-insurable events, stated that only the insurable events (death and disability) should be included in the initial succession plan.[104] He stated that the succession plan:[105]

> might include other triggers for the transfer of equity, for example unacceptable performance by a principal. I recommend that you consider not including such issues in a first generation Buy-Sell agreement for most businesses. The reason is that while an important issue, in my experience, it can complicate matters and deflect focus from the main issue, being the transfer of equity in event of death, trauma and TPD.

O'Sullivan also follows this approach:[106]

> 'Pure' buy-sell agreements raise a number of complex issues, and including other [non-insurable] matters is likely to complicate things further and deflect focus from the main issue—the transfer of equity in the event of death, trauma and TPD. Including other triggers can sometimes make the process so hard that nothing will be settled. Our suggested approach is to simplify the process by attending to the critical issues upfront.

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[99] The two most common events included under this category are the voluntary retirement and the resignation of a principal. If not planned for in advance, these voluntary departures of a principal, and with them the corresponding owner's interest, can cause conflicts. Succession planning can be valuable where the retirement or resignation comes about due to external pressures such as an economic downturn or declining profits. Under such pressures, previously amiable business relationships may deteriorate. Inter-personal conflicts may mean that the retirement or resignation of an owner may put the viability of the business at risk. This can occur if the outgoing owner wants to 'cash-in' the business interest, either by selling the interest to a third party or by seeking to wind up the business.
[100] Bobbin, above n 93, 3.
[101] Craig McKie, *Business Succession Planning* (Taxation Institute of Australia, 2008).
[102] Ibid., 8.
[103] Hockridge, above n 93.
[104] Ibid.
[105] Ibid., 4; also see generally White and MacPherson, above n 93.
[106] Bernie O'Sullivan, *Estate & Business Succession Planning 2011–12* (Taxation Institute of Australia) 348.

Non-insurable events have their own taxation consequences and, as stated in Chapter One, fall outside the scope of the research. The research limits the events to the insurable events relating to the principal's death or disability.[107] Correspondingly, the historical review is limited to succession planning funded using life, TPD and trauma insurance.

5 Finding a Preferred Model under the Australia Taxation System

The above literature shows that insurance-funded succession planning is well established in the US. Insurance-funded succession planning is also not a new concept in Australia. In this country, the majority of references to succession planning agreements appear from the mid-1990s onwards.[108] This timing corresponds to a growing realisation of the effects of the CGT introduced in Australia in 1985.[109] There was also, at this time, an increase in the availability of more flexible insurance products, such as trauma policies.[110] There was also greater public debate about the taxation system in general.[111]

Gray noted that 'before the introduction of CGT, the standard method of ownership [of the insurance policies] was cross-ownership'.[112] The agreement was triggered by the event of death or a disability pursuant to a 'mandatory buy-sell agreement'.[113] As well as being the preferred model, commentators stated that such a structure was easier to

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[107] Hockridge's approach is adopted in this research. As stated in Chapter One under Section B: Scope, non-insurable events are not considered.
[108] See, for example, Kevin Munro, *Succession Planning* (Taxation Institute of Australia, NSW Intensive Seminar, Sydney, 1995) 76, 85.
[109] Capital gains tax (CGT) was introduced in Australia as one of a number of tax reforms by the Hawke/Keating Government. CGT, in the context of the Australian taxation system, applies to the capital gain made on disposal of any asset, except for specific exemptions (such as the main residence). CGT operates by having net gains treated as taxable income in the tax year an asset is sold or otherwise disposed of.
[110] This is as set out earlier in this chapter.
[111] Graeme Cooper, *A Toe in the Water—Henry and the Tax Forum* (Taxation Institute of Australia, 44th Western Australia State Convention, Quay West Resort, Bunker Bay, 11–12 August 2011) 6, where Professor Cooper postulates that '[international] public debate about reforming tax systems achieved a prominence in recent decades which is unprecedented'.
[112] Ian Gray, 'The Tax Treatment of Self-Ownership Buy/Sell Agreements' *Complete Succession* (2011) <http://www.completesuccession.com.au/page%2003.1.0.html>. Gray also stated that:

> It is no longer normal for the Business or the Purchasers to own Buy/Sell Insurance, because of the CGT liability with respect to Non-Death Benefits. As a result, it is no longer normal to use Cross-Ownership Agreements.

[113] The word 'trigger' is a common expression used in succession planning: O'Sullivan, above n 106, 338. The concept of 'mandatory buy-sell agreements' and other ways of triggering the succession plan are set out in Chapter Six.

explain to owners.[114] Since the introduction of CGT in Australia, there is no longer consensus as to a 'preferred model'[115] of how succession planning should be structured from a taxation perspective.[116]

From 2000 to 2010, some commentators, relying on an ATO discussion paper on the taxation aspects of succession planning agreements (the ATO discussion paper)[117] believed that there was a 'preferred model'.[118] The ATO has stated that its discussion papers are merely formal papers on technical issues.[119] Discussion papers are published by the ATO to help facilitate consultation with commentators; they are neither authoritative nor binding on the ATO.[120] As the ATO itself stated, a 'technical discussion paper will not express a precedential ATO view'.[121] Nevertheless, some commentators, faced with the ambiguity in the law and little direction by the ATO, had no alternative but to rely on the ATO discussion paper. A commentator stated:[122]

> While insurance funded buy-sell arrangements have been a suggested solution for a number of years, the taxation consequences of utilising insurance-funded arrangements have been the subject of much debate. The ATO discussion paper from May 2000, still (despite its age) sets out in some detail what are considered to be the ATO's views.

Other commentators contend that the ATO discussion paper should not be relied on.[123] Some have argued that there is no 'preferred model'.[124] In any event, the ATO

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[114] Bobbin, above, n 93.

[115] The expression 'preferred model' comes from Matthew Burgess, *Estate Asset & Business Succession Planning* (Taxation Institute of Australia Business Succession Planning Forum, Brisbane, 2005) 7.

[116] Haag, Helin and Melin, 2006; Lansberg and Astrachan, 1994.

[117] S Sorbello et al., *Discussion Paper in Relation to Buy-Sell (Business Succession) Agreements* (ATO, 2000) <http://civiclegal.com.au/Publications/3051ATODiscussionPaper-BuySell.pdf> 7.

[118] Burgess, above n 115, 7, stated that 'in light of the ATO's discussion paper ... the most preferable (and conservative) structure for insurance funded buy-sell arrangements is as follows: (a) the insurance policies should be self-owned'.

[119] ATO, *Technical Discussion Papers*, PS LA 2010/5, 2 December 2010 [1].

[120] As to the operation, effect and purpose of a 'discussion paper', see Ibid. and ATO, *Practice Statement Law Administration*, PS LA 2008/3.

[121] ATO, PS LA 2010/5[9].

[122] Burgess, above n 115, 4.

[123] See, for example, McKie, above n 101, 7 in which McKie stated that 'Concerns have been expressed as to whether the ATO will follow its view set out in the discussion paper'.

[124] Some commentators disagree that self-ownership (as suggested in the ATO discussion paper) is the preferred model. See, for example, McKie, above n 101, 13, where he stated that 'Due to the above issues, it may be appropriate to hold the insurance policy within a superannuation fund'.

discussion paper has now been withdrawn by the ATO.[125] Any certainty that may have been derived from the ATO discussion paper has been lost.[126]

In contrast, in the US, Dr Anthony Fantini stated that insurance for succession planning is mostly held in one of two ways.[127] These are by way of cross-ownership or by redemption of shares (company ownership).[128] When compared to Australia, the taxation rules in the US for succession planning are settled and certain. This has enabled the development of these two main agreed upon approaches to the succession planning process in the US.[129] In view of this, the lack of a 'preferred model' in Australia may have contributed to the increased amount of literature from Australian commentators on succession planning from the 1990s.[130]

An Australian commentator, Stewart, stated that 'there has been very little guidance from the ATO about how it will treat buy-sell agreements and insurance in business succession plans'.[131] Commentators have described the taxation legislation in this area as vague, uncertain and ambiguous.[132]

This chapter demonstrates that, traditionally, before the introduction of CGT, most succession plans were structured so that the insurance was cross-owned. This was the preferred model in Australia and remains the preferred model in the US. After CGT, consensus was lost as to the best way to hold insurance in Australia, with commentators having put forward three alternative methods:[133] self-ownership, insurance trust and superannuation. The taxation issues of these models are examined in Chapter Six to

[125] On 14 March 2011, the National Tax Liaison Group issued draft Minutes of its Meeting on 14 December 2010, at http://www.ato.gov.au/taxprofessionals/PrintFriendly.aspx?ms=taxprofessionals&menuid=0&doc=/content/00271267.htm&page=13&H13>.

[126] I Grey, 'The Tax Treatment of Self-Ownership Buy/Sell Agreements' *Complete Succession*, <http://www.completesuccession.com.au/page%2006.0.26.html>, where Grey stated that, as to the withdrawal of the ATO discussion paper, 'this is a clear and unambiguous signal that the ATO does not currently endorse the Self-Ownership of Buy/Sell insurance'.

[127] Fantini, Esperti and Peterson, above n 54. Another leading US commentator, Howard M Zaritsky, generally concurs, but stated in Zaritsky, above n 79, 1.03[1] that 'the three basic forms of buy-sell agreements [were] (1) the redemption agreement; (2) the cross-purchase agreement; and (3) the hybrid agreement. These forms of agreement are very closely related'.

[128] Or, alternatively, in the case of units in a unit trust, via a redemption of units.

[129] Fantini, Esperti and Peterson, above n 54.

[130] The literature review revealed more articles written after 1985 than in the preceding period.

[131] Miranda Stewart, 'Business Succession: ATO Issues More Guidance on Buy-Sell Agreements and Insurance' (2010) 45 *Taxation in Australia* 4, 195, 195.

[132] Ibid., Timothy AO Endicott, *Vagueness in Law* (Oxford University Press, 2000).

[133] See, for example, McKie, above n 101, 10–13; Meagan O'Connor, 'Trusts and Life Insurance for Business Succession' (2010) 45 *Taxation in Australia* 5, 299.

demonstrate that the lack of consensus comes from ambiguous taxation laws and adverse CGT consequences.[134]

While the Australian literature reveals a lack of agreement as to how to structure succession plans, Australian commentators are generally supportive of the use of insurance. For example, Hockridge recommends insurance, as there is 'typically not going to be sufficient capital available for the remaining proprietors to buyout the exiting proprietor without a degree of financial pain'.[135] Burgess sees insurance as the 'new black'.[136] Prestney's book, *Family Business Succession Guide*, supports the importance of succession planning and insurance funding, stating that:[137]

> wherever possible, [succession plans should] be supported by insurance policies, covering death and TPD, which will provide a lump sum to fund the equity payout to the deceased's estate/family or, in the case of permanent disability, to the disabled family member. Trauma insurance may also be obtained which provides a lump sum payment in respect of injury or illness, or the occurrence of an event such as a heart attack or stroke.

As to the amount of literature on succession planning in Australia, Hovey stated that, while succession planning:[138]

> in family owned businesses is well documented—especially amongst authors in the US ... There is less known about ownership succession in privately owned firms. Further, there is a general lack of contemporary Australian literature on the subject.

[134] Peter Bobbin, *Business Succession Planning—Making Sure It Survives Even If You Don't* (Taxation Institute of Australia, Sheraton on the Park Hotel, 20 November 2001) 6.
[135] Hockridge, above n 93; see also Bobbin, above n 134, 8; White and MacPherson, above n 93, 9, 11.
[136] M Burgess, *Passing Control of a Business on Insurable Exit Events—Ensuring Fair Outcomes* (Taxation Institute of Australia, 18th National Tax Retreat Taxation Institute of Australia, Sheraton Noosa Resort & Spa, Noosa, 19 August 2010).
[137] Sue Prestney, *Family Business Succession Guide* (Thomson Reuters, 2010) 141.
[138] Hovey, above n 77, 5.

Likewise, Ip and Jacobs, in the UK, stated:[139]

> While it may not have received as much attention in the general management literature as one might expect, it [succession planning] is unarguably a critical issue for any corporation, team, or individual, to consider how it plans for the future.

Equally, Motwani, in the US, identifies succession planning as one of the most important topics requiring the attention of business owners as the 'baby boomers' begin to retire.[140] Jacobs stated that 'succession issues are generally applicable to organisations regardless of size, sector, and geographic location'.[141]

C. Conclusion

This chapter considered the historical significance of succession planning insurance and succession in small businesses where a principal leaves the business because of death or disability. The literature review amalgamates the available evidence and offers an insight into the historical development and current state of research and practice in succession planning. It shows that, unlike in the US, there is little consensus as to a preferred way of structuring the succession plan. This provides context on succession planning in Australia.

The literature identifies the US as an early leader in the development of succession planning.[142] Much of the literature and, in particular, the early literature, comes from the US. When compared to Australia, the US has produced a more consistent approach to succession planning. The research contends that this is because of more certain and less ambiguous taxation rules in the US. This supports the hypothesis that the taxation of insurance in Australian succession planning may benefit from reform of the legislation.

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[139] Ip and Jacobs, above n 77, 326.

[140] Jaideep Motwani, Nancy M Levenburg, Thomas V Schwarz and Charles Blankson, 'Succession Planning in SMEs: An Empirical Analysis' (2006) 24 *International Small Business Journal* 5, 471. See also Fahr, above n 96, 319.

[141] Jacobs, above n 77, 326; see also Motwani, Levenburg, Schwartz and Blankson, above n 140.

[142] As to why the US was an early a leader in the field is not known. However, some commentators argue that the small government and non-interventionist approach at the time gave business owners 'economic freedom' to develop entrepreneurial business structures. See, for example, *America's Greatest Economic Miracle* <http://www.agem.com/>.

CHAPTER FOUR: TIMING OF THE BUSINESS SUCCESSION PLANNING AGREEMENT—A SEARCH FOR CERTAINTY

A. Introduction

As discussed in Chapter Three, a business succession planning agreement aids the continuation of the business during the usually unexpected loss of a principal due to death or disability. The owners enter into an agreement and, upon a principal's death or disability, the outgoing owner sells the business interest to the remaining owners. The conflicts and other consequences documented in Chapter Two may be reduced by putting in place a succession planning agreement. The terms of the agreement are negotiated prior to the death or disability. At this time, the owners are more likely to be amicable and on relative equal footing. The alternative is attempting to negotiate a succession plan 'over the coffin' with a grieving spouse.

Chapter Three considered the historical issues regarding succession planning and insurance. It provides context for this chapter's consideration of the uncertainty as to when, for CGT purposes, the agreement is deemed to have come into effect. The chapter highlights ambiguity in the taxation legislation. This is also evidenced by the ATO and commentators' changed approaches over time. The research demonstrates that the legislation fails the benchmark dealing with simplicity for both the regulator and taxpayer.[1]

[1] The mechanics of how succession plans operate are often divided by commentators into three areas: how the succession planning agreement is structured, the events that trigger the agreement and how the insurance is structured. This chapter deals with the first issue from the perspective of the taxation consequences of the timing of the CGT event under *ITAA 1997* s 104-10 and the triggering events. See an example of this division by Chris Tsovolos, *Estate and Succession Planning, Business Succession Planning—Buy/Sell Agreements* (Taxation Institute of Australia, 2008). However, compare David Turnbull, *Business Succession Planning for Shareholders, Unitholders and Partner*s (Taxation Institute of Australia, SME Tax Intensive, 2001) 2, where Turnball stated that a 'business succession plan ... falls neatly into two parts: first the arrangements for transferring the ownership ... and second, the arrangement for funding these transactions through insurance'.

B. Importance of Ascertaining when the Agreement comes into effect

Prior to the introduction of CGT in 1985, most succession planning contracts were structured as mandatory buy-sell agreements. They were the 'standard'[2] or 'traditional'[3] way of structuring a succession plan. The structure was simple and easy to explain to clients. The mandatory buy-sell agreement provides that if a principal dies or is disabled, the remaining owners must buy and the outgoing owner must sell the business interest.[4] As discussed in Chapter Three, partly because of its simplicity, this method remains one of the two popular agreement structures in the US.

As to the agreement's timing, for CGT purposes, what may be considered a straightforward issue for an owner signing a succession planning agreement, is the subject of conjecture by the ATO and commentators. Over time, there have been different positions taken within the ATO itself and between commentators regarding when the mandatory buy-sell agreement comes into effect for CGT purposes.[5] As a result, additional ways of structuring the agreement have been developed, so that now, as well as the mandatory buy-sell agreement, there are an additional three ways to structure a succession plan.[6] These are:

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[2] Matthew Burgess, *Passing Control of a Business on Insurable Exit Events—Enduring Fair Outcomes* (Taxation Institute of Australia, 18th National Tax Retreat Taxation Institute of Australia, Sheraton Noosa Resort & Spa, Noosa, 19 August 2010) 13.

[3] Brett K Davies and Ian S McEwan, *Colonial Guide to Business Insurance* (The Colonial Mutual Life Assurance Society, 1999) 32.

[4] Greg Cahill, *Succession Planning, Restructuring and Buy and Sell Agreements* (Taxation Institute of Australia Integrated Estate and Financial Planning Day, 2002) 3; Peter White and Ian MacPherson, *Business Succession Planning Buy/Sell Agreements* (Taxation Institute of Australia, 20 September 2006) 12 described the mechanism by saying that 'once a certain event occurs (that is, death or incapacity of a principal), the outgoing principal or their representative *must* sell their interest in the business to the continuing principals, who *must* purchase those interests'. [Italics added].

[5] Cahill, above n 4, 5.

[6] A 'mutual will' is another way to structure the succession plan. A mutual Will is where the owners each agree to leave their interest in the business to the remaining owners in their Will. Outside the Wills, an agreement contractually binds the parties not to change their Wills. However, an owner can still change his Will without notifying the other owners. Such changes may not be discovered until after the owner's death. See, generally, Peter Bobbin, *Business Succession Planning—Making Sure It Survives Even If You Don't* (Taxation Institute of Australia, Sheraton on the Park Hotel, 20 November 2001) 4, where Bobbin states 'in my will, I gift to you my half of the business and in your will, you do the same'. Bobbin stated that the method is not commonly used because a 'very strong personal relationship' is required. Further, he stated that such an arrangement has 'fundamental uncertainties'. These include (even with a separate *inter vivos* agreement) the following flaws: the Will can still be changed; it covers only death, not disability; the Will can be challenged; and the remaining owners gain a 'low cost base' for CGT purposes. Since this approach is rarely used and has its own distinct taxation issues, it is not discussed further in this research.

(i) a **condition precedent**, which is based on a mandatory buy-sell agreement containing a clause expressly stating that the agreement is not formed until a certain defined condition is satisfied, such as, 'this contract is subject to and conditional upon the principal's death or disability;[7]

(ii) an **agreement to agree**, which is also based on the mandatory buy-sell agreement, is either an oral or written contract in which the parties agree to come to an agreement regarding the terms of a succession plan at some point in the future, so that the parties agree to sign a mandatory buy-sell agreement after a principal dies or is disabled and only at that time; or

(iii) a **put and call option**, which is a mutual grant of options between the owners over their interests in the business where, first, the outgoing owner grants the call option to the remaining owners, so that when the outgoing principal dies or is disabled the remaining owners may exercise the option and thus 'call' that outgoing owner's interest. Second, each owner provides a put option, so that when the outgoing principal dies or is disabled then the outgoing owner may exercise the option and thus 'put' the business interest to the remaining owners.

As identified by commentators, 'despite years of suggesting the contrary',[8] the ATO discussion paper stated that a mandatory buy-sell agreement might trigger a disposal of the business interest dating back to when the agreement was signed.[9] In that event, because of the operation of the CGT regime, the date of the CGT event of the business disposal is the date the agreement is signed, rather than the date of the principal's death or disability.[10] This is based on the Commissioner's assertion, in the ATO discussion paper, that the mandatory buy-sell agreement is a binding contract from the date it is signed as it contains immediate enforceable rights.[11]

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[7] Brett Davies Lawyers, *Condition Precedent Succession Planning Agreement* proforma (Perth, Western Australia, 2011).
[8] Burgess, above n 2, 12.
[9] S Sorbello et al., *Discussion Paper in Relation to Buy-Sell (Business Succession) Agreements* (ATO, 2000) <http://civiclegal.com.au/Publications/3051ATODiscussionPaper-BuySell.pdf> 4
[10] This is discussed below in this chapter.
[11] See, generally, *Wickman Machine Tools Sales Ltd v L Schuler AG* (1972) 2 All ER 1173, 1188, Stephenson LJ and *Maynard v Goode* (1926) 37 CLR 529, 540, Isaacs J.

The time that the succession planning agreement comes into existence is significant, as it determines the disposal date of the CGT asset for the outgoing owner's interest in the business. Further, the timing for CGT purposes, which may be the date that the agreement is signed, is significant for the following two reasons.

1 Remaining Owners gaining a Pre-CGT Status

CGT applies to the the capital gain made on disposal of certain assets. CGT operates by having net gains treated as taxable income in the tax year an asset is sold or otherwise disposed of. CGT primarily applies to assets that were acquired after 19 September 1985; it is, generally, a prospective tax. CGT is also a transaction tax, as a transaction needs to occur, usually, before CGT becomes applicable to the asset. A significant factor is ascertaining whether the remaining owners from the outgoing owner acquired the business interest before or after 19 September 1985. The fact that the purchase of the business interest by the remaining owners occurs after 1985 does not mean that this is the relevant date for CGT purposes. Where the outgoing owner transfers a pre-CGT business interest after 1985, the remaining owners may hold the business interest as if it were acquired prior to 20 September 1985. In that case, the remaining owners, although acquiring the business interest post 19 September 1985, hold the asset outside the CGT regime. For example, the owners each acquired their interest in the business prior to 20 September 1985, in 1984. They also entered into the succession plan in 1984. In 2012, a principal dies. Pursuant to the succession plan, the remaining owners purchase the outgoing owner's interest in the business. Although acquired in 2012, the remaining owners, for taxation purposes are deemed to have acquired the business interest 35 years earlier, in 1984.[12]

This advantageous position for the remaining owners comes about where:

1. the outgoing owner held the business interest prior to 20 September 1985; and

2. the succession plan was 'entered into' also prior to 20 September 1985.

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[12] This is assuming that no other section of the CGT legislation deems the asset to be subject to the CGT regime.

Even though the outgoing principal dies or is disabled after 1985, the business interest (being the CGT asset), is deemed to have been transferred before the introduction of the CGT regime. The remaining owners hold the business interest as a pre-CGT asset. The outcome is that, when the remaining owners themselves dispose of the asset, they potentially pay no CGT, as the asset is a pre-CGT asset. In this case, both the outgoing and remaining owners dispose of the asset without being liable to CGT—even though the remaining owners have the business interest transferred to them after 19 September 1985. This is provided that:

1. no income tax provision operates to treat the asset as having been disposed of after that date, such as CGT event K6 and *ITAA 1997* Division 149 in relation to companies (pursuant to ITAA 1997 section 104-5 there are 52 CGT events where each event specifies what gain, loss, or cost base adjustment are to be made and the determination of appropriate date);[13] and

2. the business interest in the hands of the outgoing owner continues to be treated as a pre-CGT asset.

(a) Specific Legislation Required to Retain Pre-CGT Status

While CGT is commonly a prospective tax, there is no general section in the *ITAA 1997* stating that pre-1985 assets are outside the CGT regime. The exemptions for assets actually or deemed to have been acquired prior to 20 September 1985 are included in each of the relevant specific CGT events. The CGT events are detailed in *ITAA 1997* Division 104. For each event, there needs to be a provision that specifically disregards any capital gain (or loss) from the relevant CGT event where the asset was acquired prior to 20 September 1985.

For example, in relation to CGT event A1, where there is a disposal of a CGT asset, *ITAA 1997* section 104-10(5)(a) states that a capital gain (or loss) is disregarded if the taxpayer acquired the asset before 20 September 1985. Similarly, for CGT event E1, being the creation of a trust over a CGT asset, *ITAA 1997* section 104-55(6) provides that the capital gain (or loss) is disregarded if the outgoing owner acquired the asset

[13] As to *ITAA 1997*, div 149 ss 149-10–149-170 set out the governing rules for when assets acquired before 20 September 1985 are deemed to be subject to CGT.

before 20 September 1985. Similarly, CGT event K6, specifically only applies to shares in a company or interests in a trust that were acquired prior to 20 September 1985.[14]

In contrast to the above-discussed CGT events A1, E1 and K6, there is no provision stating that pre-1985 assets are outside the CGT regime for CGT event D2. In the context of succession planning, CGT event D2 can arise where the remaining owners grant a put option to the outgoing owner, or renew or extend an option that was previously granted as set out in *ITAA 1997* section 104-40(1).[15] Pursuant to *ITAA 1997* section 104-40(2) the time of the event is when the option is granted, renewed or extended. Section 104-40(4) sets out the capital gain. This is based on the capital proceeds from the grant, renewal or extension of the option being greater than the expenditure incurred.[16] As CGT event D2 can only happen after 19 September 1985, there is no provision in the taxation legalisation required to exclude pre-CGT assets. Pursuant to *ITAA 1997* section 109-5(2), the effective CGT asset for CGT event D2 is the option that is granted, renewed or extended. There is no CGT asset held by the owners that could constitute a pre-CGT asset. Due to the character of this event, the asset is only created at the time of the CGT event and is immediately held by the remaining owners. The option is, therefore, never able to be a pre-CGT asset. That being the case, there is no provision (and no need for a provision) that disregards a capital gain or a capital loss made for a CGT event D2 for a pre-CGT asset. The pre-CGT grant, renewal or extension of the option cannot occur in the year of income.

In summary, as to pre-CGT assets, in particular circumstances, as will be discussed in this chapter, the timing of the succession planning agreement determines whether the interest in the business remains pre-CGT. For example, the outgoing principal dies. The outgoing owner is transferring the business interest after 19 September 1985. The business interest retains its pre-CGT status in the hands of the remaining owners. Therefore, no CGT is applicable on a disposal by the remaining owners.

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[14] *ITAA 1997* s 104-230.

[15] CGT event D2 is discussed later in this chapter.

[16] Similarly, pursuant to s 104-40(4) *ITAA 1997*, a capital loss arises where the expenditure incurred in the grant, renewal or extension of the option exceeds the capital proceeds.

2 Outgoing Owner Losing the 50 Per Cent CGT Discount[17]

Depending on the business structure, the outgoing owner may be entitled to a concession of one-half of the capital gain if the business interest is held for over 12 months.[18] An outgoing owner that is deemed under the CGT regime to have entered into the succession planning agreement within 12 months of first acquiring the business interest is not entitled to the 50 per cent CGT discount.[19] Specifically, *ITAA 1997* section 115-40 states that the 'capital gain on a CGT asset from a CGT event is not a discount gain … if the CGT event occurred under an agreement you made within 12 months of acquiring the CGT asset'.[20]

The effect is that the deemed date of disposal—for example, the date the succession planning agreement was signed—may be within 12 months of the date the business interest was originally acquired by the outgoing owner. The actual date that the outgoing principal died or suffered the disability is not relevant for this calculation. This is the case even though such events may have happened after 12 months from the acquisition of the business.

C. Ascertaining the Deemed Time of the Creation of the Succession Planning Agreement

For the two reasons set out above, ascertaining the time that the succession planning agreement commenced is important. The succession planning agreement's structure

[17] Alternatively, instead of applying the 50 per cent concession for an interest in the business acquired prior to September 1999 (provided the assets are subject to the CGT regime), the outgoing owner can choose instead to apply an indexed (linked to inflation) cost base. However, this is not considered further here, as it would rarely be to the taxpayer's benefit to use indexing, as indexing was frozen in 1999. The concession amount is different for superannuation funds and depends on the business structure. The discount for complying superannuation funds is one-third (rather than one-half), but is not considered in this research, as it is unlikely that the business interest would be held in a superannuation fund.

[18] ATO, *Income Tax: Capital Gains: What is Meant by the Phrase 'At Least 12 Months Before' in Subsection 114-10(1) of the Income Tax Assessment Act 1997 (About Indexation) and Subsection 115-25(1) (About the CGT Discount)?* TD 2002/10, 15 May 2002. For a discussion on this TD, see Robin Woellner et al., *Australian Taxation Law* (CCH Australia Ltd, 21st ed, 2011) 396, fn 39.

[19] Greg Cahill, 'The ATO Statement of Principles in Relation to Buy-Sell (Business Succession Agreements)' [2001] *Financial Planner's Digest* 2, 6.

[20] The discount was introduced and applies from 21 September 1999. The discount is available only to individuals and trusts. It is not available to companies. However, it is potentially available if a company owns the business and the outgoing owner holds the shares as an individual or in a trust. However, a company may offset a net capital loss against a capital gain if it passes either the continuity of ownership test or the same business test in relation to both the capital loss year, the capital gain year or any intervening years.

can affect the timing for CGT purposes.[21] Pursuant to *ITAA 1997* section 109-5(1), the date the taxpayer acquires an interest in the business is the relevant date of acquisition. An exception to this general rule is CGT event A1.[22] *ITAA 1997* section 104-10(3) deals with the timing of CGT event A1; this is when the disposal of a CGT asset is deemed to have occurred.[23] It states:[24]

> (3) The time of the event is:
>
> > (a) when you enter into the contract for the disposal; or
> >
> > (b) if there is no contract—when the change of ownership occurs.

For *ITAA 1997* section 104-10(3), the deemed CGT disposal date may be the date the succession planning agreement is signed. Yet, the principal's death or disability may happen years after this date. Ascertaining with certainty when CGT event A1 occurs is, therefore, important. Is this when the agreement is signed (paragraph a) or when the business interest is transferred due to the principal's death or disability (paragraph b)? As to the mandatory buy-sell agreement, this issue was considered in the ATO discussion paper, which stated:[25]

> However, if it is truly clear from the intention of the parties that they entered into a binding agreement at the date of signing, the consequence will be that, although the actual change of ownership will not occur until the date of death, the time of the event for CGT purposes will be the time the contract was entered into. This will mean that any change of ownership as a result of the death or disablement of an outgoing proprietor will be deemed to have occurred at the time the contract was entered into and the return for that year will have to be amended to reflect the disposal by the outgoing

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[21] The implications of the CGT regime are examined in more detail in Chapter Five.

[22] According to the *ITAA 1997* s 102-25, a capital gain or loss for taxation purposes can only arise if there is an occurrence of a CGT event. CGT events are defined exhaustively in div 104 *ITAA 1997.* CGT events are discussed in more detail below in both this chapter and in Chapter Five.

[23] Previously s 160U(3) *ITAA 1936*. Div 104 (where s 104-10 is situated) was inserted into the *ITAA 1997* by the *Tax Law Improvement Act (No. 1) 1998*, receiving Royal Assent on 22 June 1998 and taking effect from that date. Therefore, on 22 June 1998, s 160U(3) was replaced by s 104-10(3). *ITAA 1997* s 104-10 was rewritten, and the latest section has only been in effect from the 1999 income year.

[24] The time of CGT event A1 is either when the taxpayer enters into the contract for the disposal or, if there is no contract, when the change of ownership occurs: s 104-10(3). If the agreement is not completed, then there is no change in ownership or CGT event A1: s 104-10(3) Note 1. This is considered further in this chapter.

[25] Sorbello et al., above n 9, 7. As set out in Chapter Three, the discussion paper has now been withdrawn.

> proprietor and acquisition by the remaining proprietors, even though the actual disposal (and acquisition) may have occurred many years later.

Some commentators disagreed with this ATO position because consideration is only paid upon a contingent event, being the death or disability.[26] Thus, pursuant to this reasoning, and in contrast to the ATO's position, the event would not occur until the death or disability. If this were the case, the CGT event would occur at the date of an outgoing principal's death or disability.

If the commentators are wrong, paragraph (a) applies, and the disposal of the business interest is deemed to have occurred when the agreement was first 'entered into'. This requires a recalculation of the outgoing owner's CGT liability dating back to the date the agreement was signed, with the taxation return duly amended. *ITAA 1936* section 170 (10AA) allows the Commissioner to amend such returns without any time limit.[27]

There is no general rule in the *ITAA 1997* that states that the taxpayer reports the capital gain in the year in which the disposal occurred. For event A1, the time of reporting is specifically set out in *ITAA 1997* section 104-10. The realised capital gain under CGT event A1 is not reportable until the financial year that the actual change of ownership occurs.

As required by *ITAA 1997* section 102-5, the outgoing owner's assessable income includes the net capital gain for the financial year.[28] Such capital gain includes CGT event A1 that is a disposal under *ITAA 1997* section 104-10(4). However, CGT event A1 only happens if the owner actually disposes of the business interest.[29] A disposal of the business interest only occurs if a change of ownership happens from the outgoing owner to the remaining owners, 'whether because of some act or event or by operation

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[26] Matthew Burgess, *Succession Agreements and Insurance Trusts* (Taxation Institute of Australia, Taxation Conference Series 3, 2001) 4. This issue is considered later in this chapter.
[27] This 'qualification', as stated in *ITAA 1936* s 170, overrides the general provision also found in *ITAA 1936* s 170, being 'The Commissioner may amend an assessment of an individual for a year of income within 2 years after the day on which the Commissioner gives notice of the assessment to the individual'. The Federal Court confirmed the Commissioner's power to amend an assessment at any time to give effect to the specific CGT event timing rule in *ITAA 1997* s 104-10(3) in *In Metlife Insurance Ltd v FCT* (2008) ATC 20-025; 70 ATR 125, and on appeal (2008) ATC 20-049; 70 ATR 364.
[28] *ITAA 1997* s 102-5(1) states, in part '(1) Your assessable income includes your net capital gain (if any) for the income year'. The method of offsetting the capital gain and capital losses made in a financial year is set out in *ITAA 1997* s 102-5.
[29] *ITAA 1997* s 104-10(1).

of law'.[30] While alive and not disabled, there is no disposal or change of ownership. In that case, pursuant to *ITAA 1997* section 104-10(3) Note 1, the CGT event never happened.[31] Note 1 states that: '[i]f the contract falls through before completion, this event does not happen because no change in ownership occurs'.

The use of the expression 'falls through' in Note 1 suggests that one of the parties is defaulting or fails to perform under the agreement.[32] An example of defaulting is a party being unable or unwilling to carry out the terms of the agreement. Neither is the case in a succession plan. The principal merely continues to live and does not suffer from a disability. There is no defaulting party and it is inappropriate to refer to the agreement as 'falling through'. The legislative wording is another example of where the legislation is not specifically drafted to reflect the nature of a succession planning agreement.

Owing to the operation of *ITAA 1997* sections 102-5 and 104-10, where the agreement is 'entered into' in one financial year but the business interest is disposed of in a later year, the outgoing owner is required to include a capital gain (or loss) in the financial year the succession plan was 'entered into'. This is rather than the subsequent year in which the transfer of the business interest took place. CGT event A1 will not occur if settlement of the transfer of the business interest does not proceed. The outgoing owner's capital gain (or loss) is not included in the relevant financial year until an actual change in ownership occurs. The Commissioner accepted this interpretation in Taxation Determination TD 94/89 and stated:[33]

> However, a taxpayer is not required to include any capital gain or loss in the appropriate year until an actual change of ownership occurs. Settlement effects a change of

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[30] *ITAA 1997* s 104-10(2).

[31] The *ITAA 1997* contains a number of 'notes'. While they form part of this Act (*ITAA 1997* s 950-100), they are 'non-operative' material, rather than 'guides': *ITAA 1997* s 2-45. Their purpose is to assist the taxpayer understand the related section. As they form part of the *ITAA 1997,* they are of significance for interpreting the *ITAA 1997*. That is, these elements are not 'extrinsic' materials and can be more readily taken into account in interpreting the legislation. 'Guides', while also 'non-operative material' and forming part of the Act, are limited to how they interpret the related operative provision: s 950-150. Notes and examples are not specifically so limited. In contrast, footnotes, endnotes and tables are of lesser interpretive value, as they do not form part of the Act: *ITAA 1997* s 950-105.

[32] For a use of the expression 'defaulting' in an agreement 'falling through', see ATO, *Income Tax: Capital Gains Tax Consequences of a Contract for the Sale of Land Falling Through*, TR 94/29, 6 October 1994, 1, which states:

> Where a terms contract falls through before completion, s 160M(4) will undo the deeming effect of s 160M(3)(d). Section 160M(4) provides that a change in ownership is not taken to have occurred if the period for which the purchaser had the use and enjoyment of the land terminates without the title to the land passing to the purchaser.

[33] This is in regards to the earlier equivalent sections contained in *ITAA 1936*.

> ownership and a disposal (section 160M(1)) which then triggers the operation of section 160U(3). When settlement occurs, the taxpayer is then required to include any capital gain or loss in the year of income in which the contract was made (section 160U(3)). If an assessment has already been made for that year of income, the taxpayer may need to have that assessment amended.[34]

As a practical issue, there may be difficulty in determining the composition of the CGT asset as it was when the agreement was 'entered into'. The ATO may also impose penalties and the general interest charge calculated from the year in which the taxation return was required to have been lodged with the capital gain.[35]

This legislation fails the standards set by the taxation benchmarks. First, it is not efficient, as it does not encourage business owners to enter into a traditional mandatory buy-sell agreement because of the threat of retrospective CGT.[36] Second, it fails the equity and fairness tests, as it is not generally possible to foretell when a person will die or suffer a disability. Yet the legislation requires a taxation return be lodged regardless and then later amended. It is also not possible for the outgoing owner to know the future value of the business interest. The taxation system in this question of timing for CGT purposes for succession planning does not work appropriately in the above transactions.

The ATO's position from the ATO discussion paper, as to the timing of the CGT event A1, was further considered in the Commissioner's Interpretative Decision ID 2004/668, in which the question was posed:[37]

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[34] This is the most recent ruling and remains current. As to the ruling referring to old sections contained in the *ITAA 1936*, the ruling states in the preamble that 'This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect'.

[35] *ITAA 1997* sch 1 pt 4-25. However, in ATO, *Income Tax: Capital Gains: In What Year of Income is a Taxpayer Required for Tax Purposes to Include a Capital Gain or Loss in Relation to Land Disposed of Under a Contract Which is Made in One Year of Income, But Which is Settled in a Later Year of Income?* TD 94/89, 24 November 1994, the ATO indicated that interest penalties might be remitted. This is where the amended return is lodged promptly after the actual disposal occurs. However, ATO TD 94/89 cl 5 stated:

> remission of interest will be dealt with in each case on its own merits … [and] would ordinarily be exercised to remit the interest in full where requests for amendment are lodged, and where relevant, self-amendments are made, within a reasonable time after the date of settlement. In most cases, we would consider a period of one month after settlement to be a reasonable period.

This requires the outgoing owner to know of the ATO's position and act in a timely manner.

[36] *ITAA 1997* sch 1 pt 4-25.

[37] ATO, *Capital Gains Tax: Buy-Sell Agreement—Time of CGT Event A1,* ID 2004/668, 23 July 2004. This replaced ATO ID 2002/765.

> Is a buy-sell agreement 'entered into' for the purposes of *ITAA 1997* section 104-10(3)(a) before a condition precedent to its formation is fulfilled?

To the taxpayer's benefit, Interpretative Decision ID 2004/668 stated that the succession planning agreement is not 'entered into' until the 'condition precedent' (death or disability) is satisfied. The term 'condition precedent' is not defined. However, the ID concludes:[38]

> the language used to describe the condition evidenced the parties' intention not to be bound by it from the date it was signed. That is, it was a condition precedent to the formation of the agreement. Accordingly, no agreement will be entered into for the purposes of CGT event A1 until the death of a party to the contract. When a party subsequently dies, there will only be a contract in respect of the assets being disposed of by that party. Subsequent contracts will be made when other parties die.

To comply with the ID, the owners need to ensure that the succession planning agreement is not enforceable until a trigger event occurs: being a 'condition precedent' for the formation of the agreement. Failure to include a complying condition precedent may trigger CGT event A1, where the business interest is transferred, dating back to when the agreement was signed.

The ID represents a deviation from its position in the ATO discussion paper. The ID favours the disposal taking place at the time of the transfer of the business interest under section 104-10(3)(b). This is even the case where the succession planning agreement is structured as a standard mandatory buy-sell agreement.[39] The ID also supports the approach taken by some commentators. Cahill, for example, stated that 'an agreement which provides for the sale of a business interest on death/disability will not trigger an immediate disposal at the date of signing of the agreement'.[40] However, the CGT implications depend upon whether the death or disability under the agreement was a condition precedent or subsequent.[41] The cases of *Meehan v Jones*[42] (where a contract for the purchase of property was *'subject to suitable finance being available'* and the

[38] Ibid., 2 (final para).
[39] Burgess, above n 2, 13.
[40] Cahill, above n 4, 5.
[41] Ibid., Cahill stated that 'The issue of whether a condition is a condition precedent or a condition subsequent is a complex one involving fine legal distinctions'.
[42] [1982] 149 CLR 571.

purchaser told the vendor that satisfactory finance was found, but the vendor refused to complete) and *George v Roach,*[43] (concerning the sale of a business where unless a valuation is made the parties have not agreed upon the sale price of the subject matter of the agreement and the agreement does not become effective) demonstrate that the issue of whether a condition is a condition precedent or a condition subsequent is a complex one involving fine legal distinctions.[44]

ATO Interpretative Decisions, including the above ID 2004/668, are not binding on the ATO or the courts.[45] Without specific guidance from the court, given the ambiguity of section 104-10(3), there is uncertainty as to when a mandatory buy-sell agreement comes into effect for CGT purposes.

3 First Attempt at Certainty—Condition Precedent

Commentators looked to remove doubt as to the deemed timing issues surrounding section 104-10(3) by creating two variations of the mandatory buy-sell agreement. The first variation, based on the comments of the above-discussed ID 2004/668, was structuring the mandatory buy-sell agreement with a 'condition precedent'.[46] However, these structures are also problematic under the CGT regime, as some courts have decided that 'in a sense all conditions are precedent, some to an agreement beginning, and others to it continuing'.[47] In contrast, other courts have held that a condition precedent is a condition that must be satisfied for the formation of the contract.[48]

As to the 'condition precedent' being a condition that must be satisfied before the contract begins, the High Court, in *Perri v Coolangatta Investments Pty Ltd*, held that the condition precedent agreement is still a binding contract:[49]

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[43][1943] 67 CLR 253.
[44] Cahill, above n 4, 5.
[45] Rather, the ATO officers use them to help guide their technical decision making. They are not advice. They merely indicate how the legislation might apply. While not binding on the ATO, if the taxpayer acted in good faith, there may be remission on part of the general interest charge. See ATO, *Provision of Advice and Guidance by the Tax Office*, PS LA 2008/3.
[46] The second variation is the 'agreement to agree', which is considered in the next section of this chapter.
[47] *Wickman Machine Tools Sales Ltd v L Schuler AG* (1972) 2 All ER 1173, 1188, Stephenson LJ.
[48] *Maynard v Goode* [1926] HCA 4; (1926) 37 CLR 529, 540, Isaacs J. The court stated that other types of conditions (for example, to the performance of a particular term of the contract) are condition subsequent and are binding from the start.
[49] (1982) 149 CLR 537, 552, Mason J.

> which makes the stipulated event a condition precedent to the duty of one party, or perhaps of both parties, to perform. Furthermore, it gives the courts greater scope in determining and adjusting the rights of the parties. For these reasons, the condition will not be construed as a condition precedent to the formation of a contract unless the contract read as a whole plainly compels this conclusion.

As considered above, the ATO discussion paper stated that it is possible for mandatory buy-sell agreements to contain a condition precedent to the formation of the agreement.[50] *Kiwi Brands Pty Ltd v FCT*[51] decided that, for the purposes of calculating CGT under *ITAA 1997* section 104-10, the date that the condition precedent is satisfied is the appropriate date rather than the date that the agreement is signed.[52] However, care has to be taken in the drafting of the agreement to ensure that it is subject to a condition precedent, as Gibbs CJ noted in *Perri v Coolangatta Investments Pty Ltd*:[53]

> It has sometimes proved difficult to decide whether a particular condition of a contract should be classified as a condition precedent or a condition subsequent ... however, provided the effect of the condition is clearly understood, its classification may be merely a matter of words.

Commentators point out that relying on a condition precedent is of concern because of its complexity.[54] They note that, unless clearly drafted, the agreement can not only have immediate CGT consequences, but can also attract State and Territorial transfer duty at *ad valorem* rates.[55] Such concern may be lessened. In a succession planning agreement containing a condition precedent, there is less certainty. The vendor and the purchasers are not known, nor is the value of the interests involved. There is only certainty when a

[50] See generally, Sorbello et al., above n 9, 7.
[51] (1999) 99 ATC 4001.
[52] This is also the case for the option agreements discussed below.
[53] (1982) 149 CLR 537.
[54] For example, Bobbin, above n 6, 5.
[55] Ibid. Avoiding lodging the agreement to avoid the duty, apart from being against the law, renders the agreement legally invalid and, therefore, unenforceable. Transfer duty applies in each Australian State and Territory as follows:

- Australian Capital Territory: see ch 2 of the *Duties Act 1999* (ACT) and in particular s 7(1)(a).
- New South Wales: see ch 2 of the *Duties Act 1997* (NSW) and in particular s 8(1)(a).
- Northern Territory: see pt 2 ss 4 and 5(1)(a) of the *Stamp Duty Act 2008* (NT).
- Queensland: see ch 2 of the *Duties Act 2001* (Qld) and in particular s 9(1)(a).
- South Australia: see s 4 and sch 2 (Item 4) of the *Stamp Duties Act 1923* (SA).
- Tasmania: see ch 2 of the *Duties Act 2001* (Tas) and in particular s 6(1)(a).
- Victoria: see ch 2 of the *Duties Act 2001* (Vic) and in particular s 7(1)(a).
- Western Australia: see ch 2 of the *Duties Act 2008* (WA) and in particular s 11(1)(a).

principal dies or is disabled. Subject to restrictions such as pre-emptive rights, the owners are free to negotiate among themselves the sale of their business interest until the time of a principal's death or disability.[56] Nevertheless, risk and uncertainty exists in the drafting.

4 Second Attempt at Certainty—'Agreements to Agree'

In an attempt to overcome the potential early triggering of CGT event A1 in the mandatory buy-sell agreement and to remove themselves from the legislative ambiguity, some owners started to structure the agreement as an 'agreement to agree'. The colloquially called 'agreement to agree' consists of two agreements. The first agreement is agreed to by the parties. The second agreement is unsigned. The first agreement states that if a condition is fulfilled, the parties agree to sign and enter into a mandatory buy-sell agreement.[57] Specifically, in a succession plan, the parties first agree to the 'agreement to agree'. Second, upon the outgoing principal's death or disability, the parties are obliged to sign the second agreement, being a mandatory buy-sell agreement.

The agreement to agree is either oral or written. However, if there is nothing in writing, enforceability may be an issue.[58] Bobbin stated that:[59]

> No one ever intends [this] 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.

In at least one US State, legislation prohibits the enforcement of such oral agreements.[60] The New South Wales (NSW) Supreme Court case, *Rae v Beddison Corporation Pty Ltd*, provides an example of the difficulties in enforcing oral agreements, especially the issue that the parties may not have adequately addressed all aspects of the sale. In that

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[56] As to pre-emptive rights, see Chapter Two of this research.

[57] The mandatory buy-sell agreement is usually attached as a schedule to the 'agreement to agree'.

[58] As to the enforcement of verbal agreements, see, for example, *Ridgway v Wharton* (1857) 10 ER 1287, where the signed document referred to 'instructions', which themselves were verbal. In this case, the House of Lords decided that parol evidence was sufficient and admissible to support the signed document. Verbal evidence can therefore be used to substantiate written documents. Moreover 'parol evidence might be given to identify the instructions referred to with certain instructions in writing' per Field J, *Cave v Hastings* (1881) 7 QBD 125, 128.

[59] Bobbin, above n 6, 4.

[60] See *Sanders v McMullen* (1989) 868 F2d 1465 (5th Circuit), relating to Texas legislation. See also, the Statute of Frauds, 'Charles II, 1677: An Act for Prevention of Frauds and Perjuryes', *Statutes of the Realm*, Volume 5: 1628–80 (1819) 839–42, although this is now limited to primarily real property.

case, there was an oral agreement for the sale of a business.[61] The parties disputed whether the salary included superannuation and one of the parties questioned the enforceability of the agreement because it was not committed to writing.

However, there have been cases in which oral succession planning agreements and business transfers have been enforced by the court in both the US and in Australia.[62] For example, the Victorian Supreme Court of Appeal, in *Lowery v Drennan*, enforced an oral agreement for the sale of shares.[63] Similarly, in *Forrest v Appleyard*,[64] the shareholder agreed to retire from the company and transfer his shares pursuant to an alleged oral agreement.[65]

Assuming the oral agreement is enforceable, the date that the oral agreement is 'entered into' may be the relevant date for CGT purposes under *ITAA 1997* section 104-10, rather than the date that the subsequent mandatory buy-sell agreement is signed. In *McDonald v FCT*, the Full Federal Court held that the capital gain derived from the sale of a property was subject to CGT.[66] This was in circumstances in which the parties had failed to demonstrate that an oral contract had been made prior to the introduction of the CGT regime, but in which the written contracts were not exchanged until post-CGT.[67] The court decided that, at the time the oral statements were made, there was no intention to create legal relations until the agreement was committed to writing. While this oral agreement was not enforceable in this instance, the court noted in obiter dicta, that:[68]

> If the asset is disposed of under a contract, the time of CGT event A1 is when the taxpayer enters into the contract. For this purpose, a contract may be an oral contract,

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[61] [2009] NSWSC 27.
[62] For example, in the US see *Merlino v West Coast Macaroni Mfg Co* (1949) 202 P2d 748 (Cal District Court of Appeal); *Shubin v Surchin* (1967) 27 AD2d 452 (New York App Division); *Waserman v Rosengarden* (1980) 84 Ill App 3d 713, 406 NE2d 131.
[63] [2010] VSCA 239.
[64] [2006] NSWSC 281.
[65] Also in *Rae v Beddison Corporation Pty Ltd* [2009] NSWSC 27, discussed above, the court enforced the oral agreement for the sale of shares in the business; see also *Knowledge Business Accelerator Ltd v Reiner* (2003) NSWSC 435, Nicholas J. Compare these cases in which the oral agreements over the business assets were not enforced: *National Exchange Pty Ltd v Vane* [2003] VSC 361, Osborn J; *Wright v Somerton* (2004) QSC 231, Douglas J; and *QLD Holdings -1 Pty Ltd v Collingwood Holdings Pty Ltd* [2009] NSWSC 732, White J.
[66] (2001) 46 ATR 426, (2001) ATC 4146 (leave to appeal to High Court denied) 4159.
[67] That is prior to the introduction of the CGT regime. The tax applies only to assets acquired on or after that date.
[68] *McDonald v FCT* (2001) ATC 4146 (leave to appeal to High Court denied) 4159, per Stone J (Beaumont ACJ and Gyles J agreeing).

> provided it has the attributes required by common law, for example an intention by both parties to be bound by it.[69]

In this case, the facts related to real property and the *Statute of Frauds 1677* (UK) sections 4 and 17 and the Australian State and Territory replacements of the Act.[70] The Act generally does not allow the enforcement of oral contracts over land.[71] Under NSW conveyancing practice,[72] a binding contract for the sale of land would not normally be entered into until there was an exchange of written contracts.[73]

This is in contrast to the Victorian transfer of land case, *Gardiner v FCT*.[74] In that case, the oral contract was deemed the time of the disposal for CGT purposes (which was prior to the introduction of CGT), rather than two months later when the agreement was committed to writing (by which time CGT had commenced). The parties' agents had written to each other, and while no contract was signed, money was paid pursuant to the correspondence.

In *McDonald's* case, the court held there to be insufficient evidence of the oral agreement or that the oral agreement was so uncertain as to be unenforceable.[75] In contrast, in *Gardiner's* case, there was sufficient evidence of the oral agreement and it was, therefore, enforced by that court. In summary, there are two main issues. First, the

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[69] The *Statute of Frauds*, generally, requires certain transactions, such as ones relating to land, to be in writing, to be enforceable. *Statute of Frauds 1677* s 4 in part provides that 'no action shall be brought ... unless the agreement upon which such action shall be brought, or some memorandum or note thereof shall be in writing, and signed by the party'. *Statute of Frauds 1677* s 17 in part provides:

> no contract for the sale of any goods, wares, or merchandises, for the price of ten pounds sterling or upwards, shall be allowed to be good, except the buyer shall accept part of the goods so sold, and actually receive the same, or give something in earnest to bind the bargain, or in part of payment, or that some note or memorandum in writing of the said bargain be made and signed by the parties to be charged by such contract.

For a historical account, see Allan and Hiscock, *Law of Contract in Australia* (CCH Australia Limited, 1987).

[70] The *Statute of Frauds* was adopted by the colonies, but has been replaced with state legislation. See, for example, *Conveyancing Act 1919* (NSW) s 54A, *Instruments Act 1958* (Vic) s 126, *Property Law Act 1974* (Qld) s 59. Australian courts still refer to the *Statute of Frauds* for purposes of interpretation. See, for example, *Pavey & Matthews Pty Ltd v Paul* (1986) 162 CLR 221, where the High Court of Australia applied cases dealing with *Statute of Frauds* s 4.

[71] There are a number of other types of agreements, apart from transactions concerning land, which must also be in writing, as per the requirements of the relevant acts. These include: assignments of life insurance policies: *Life Insurance Act* 1955 (Cth); bills of exchange and promissory notes: *Bills of Exchange Act 1909* (Cth); cheques: *Cheques Act 1986* (Cth) and contracts of marine insurance: *Marine Insurance Act 1909* (Cth).

[72] *Conveyancing Act 1919* (NSW) s 54A.

[73] *McDonald v FCT* (2001) ATC 4146.

[74] (2000) ATC 2018; (2000) 44 ATR 1065, [2000] AATA 257.

[75] *McDonald v FCT* (1998) ATC 4306, per Finn J [4308].

oral agreement may be harder to enforce because of the evidentiary burden of proving what the parties intended. Second, the oral agreement may still be subject to CGT event A1 at the time it was entered into.

To avoid these two issues, owners entered into written 'agreements to agree', which were comprised of two written agreements—one signed and one unsigned. However, it may be the case, just as with oral agreements to agree, that the date of the signed agreement to agree is the relevant date for calculating capital gains for CGT event A1.[76] The High Court in *FCT v Sara Lee Household* ('*Sara Lee*') stated that:[77]

> Where there are two or more contracts which affect the rights and obligations of the parties to a disposal of assets, the identification of the contract under which the assets were disposed of, for the purpose of applying section 160U of the Act [now section 104-10(3) *ITAA 1997*], requires a judgment as to which of the contracts is properly to be seen as the source of the obligation to effect the disposal.

It may also be open for the Commissioner to argue that the 'agreement to agree' has the dominant purpose of reducing taxation obligations that may fall foul of the general anti-avoidance provisions found in *ITAA 1936* Part IVA.[78] This is because the parties obtained a 'tax benefit' that would not have been available if the 'scheme' had not been

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[76] However, cf *Elmslie v FCT* 93 ATC 4964; 118 ALR 357; 26 ATR 611; (1993) 46 FCR 576, as cited by Burgess, above n 2, 12. In *Elmslie*, there was also more than one contract and Wilcox J decided that the relevant contract was the one that was the immediate means by which the asset was acquired, not necessarily the first one. Compare to *Kiwi Brands Pty Ltd v FCT* 99 ATC 4001, as mentioned in Woellner et al., above n 18.

[77] (2000) 201 CLR 520, 529 [49], per Gleeson CJ, Gaudron, McHugh and Hayne JJ; see also *CC (New South Wales) Pty Ltd (in liq) v FCT* (1997) 34 ATR 604; *Clough Engineering Ltd v FCT* (1997) 35 ATR 1164; *FCT v Consolidated Press Holdings Ltd* (2001) 207 CLR 235; *FCT v Cooke* (2004) 55 ATR 183; *Eastern Nitrogen Ltd v FCT* (2001) 108 FCR 27; *Egan v FCT* (2001) 47 ATR 1180; *Electricity Supply Industry Superannuation (Qld) Ltd v DFCT* (2003) 199 ALR 339; *Essenbourne Pty Ltd v FCT* (2002) 51 ATR 629; *Fletcher v FCT* (1988) 19 FCR 442; *Grollo Nominees Pty Ltd v FCT* (1997) 73 FCR 452; *FCT v Hart* (2004) 206 ALR 207; *Howland-Rose v FCT* (2002) 118 FCR 61; *FCT v Jackson* (1990) 27 FCR 1; *Jones v FCT* (2003) 52 ATR 1063; *Kordan Pty Ltd v FCT* (2000) 46 ATR 191; *Krampel Newman Partners Pty Ltd v FCT* (2003) 126 FCR 561; *FCT v MacArthur* (2003) 53 ATR 636; *Meredith v FCT* (2002) 125 FCR 308; *FCT v Metal Manufacturers Ltd* (2001) 108 FCR 150; *FCT v Mochkin* (2003) 127 FCR 185; *Osborne v FCT* (1995) 30 ATR 464; *FCT v Peabody* (1994) 181 CLR 359; *Puzey v FCT* (2004) 54 ATR 822; *FCT v Sleight* (2004) ATC 4477; *FCT v Spotless Services Ltd* (1996) 186 CLR 404; *FCT v Stokes* (1996) 72 FCR 160; *Vincent v FCT* (2002) 124 FCR 350; *WD & HO Wills (Australia) Pty Ltd v FCT* (1996) 65 FCR 298; *FCT v Zoffanies Pty Ltd* (2003) 54 ATR 280; and *Spotlight Stores Pty Ltd v FCT* (2004) 55 ATR 745.

[78] Part IVA, comprising ss 177A to 177G inclusive, was introduced in 1981, replacing s 260 as the general anti-avoidance provision of the *ITAA 1936* for schemes entered into or carried out after 27 May 1981.

entered into.[79] The sole or dominant purpose of entering into the 'agreement to agreement' was to obtain the tax benefit.[80] The substantiation of a breach of Part IVA means that the taxation benefit is lost.

5 Third Attempt: Complete Abandonment of the Buy-Sell—Put and Call Option

Mandatory buy-sell agreements, even if drafted to include 'agreements to agree' or condition precedents, for the reasons stated above, have taxation complexity and ambiguity as to timing. In particular, as well as a condition precedent being difficult to explain to clients, there is a risk that the ATO or the courts may not hold the view that the condition is a condition precedent to the formation of the agreement. In an abandonment of the mandatory buy-sell agreement and its two variations, the owners can use put and call options.

Under a mandatory buy-sell agreement, upon the occurrence of a trigger event (such as the principal's death or disability), the outgoing owner has no choice but to transfer the business interest to the remaining owners. The remaining owners have no choice but to acquire the business interest. There are no such mandatory requirements in either a put or call option. With put and call options, each owner, depending as to whether it is a put or a call, is a grantor and grantee of the respective option.[81] An option does not come into effect unless it is exercised. If neither the outgoing owner nor the remaining owners exercise their options, there is no transfer pursuant to the succession planning agreement.

If the option is exercised, as with the mandatory buy-sell agreement, the remaining owners have neither choice nor discretion: the remaining owners must purchase the business interest from the outgoing owner. The put option allows the outgoing owner to force the remaining owners to buy the outgoing owner's interest. This provides certainty for the outgoing owner. Each owner provides a put option to the other owners.

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[79] S 177A(1) defines the term 'scheme' widely as:

> (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
> (b) any scheme, plan, proposal, action, course of action or course of conduct.

[80] For an explanation on the operation of Part IVA, see Robert O'Connor QC, *Commentary on Paper by Chris Bevan on Part IVA Amendments* (Taxation Institute of Australia, 21 June 2000).

[81] Most put and call options are separate, but contained within the same succession planning agreement. Even if they were combined, there would still be two assets for CGT purposes. See *ITAA 1997* s 116-70.

The outgoing owner can exercise the put option, or the remaining owners can exercise the call option. The result is the same: the outgoing owner must sell the business interest to the remaining owners, who must acquire the interest in the business. There is no compulsion for any of the parties to exercise an option. If neither the put nor the call option is exercised, the outgoing owner simply retains the business interest. It could be argued that this provides greater flexibility over the mandatory buy-sell agreement. The parties can seek to negotiate mutually better terms or more taxation effective outcomes with the knowledge that either party is at liberty to fall back onto the rights afforded by the options.[82] However, it is open for the parties to any contract (such as a mandatory buy-sell agreement) to come together to vary the terms of that contract.[83]

As to the current popularity of put and call options, Bobbin argues that '[i]t is almost universally accepted by taxation specialists that the best approach is the use of put and call options'.[84] Similarly, Burgess has stated that:[85]

> [d]ue to longstanding (and significant) uncertainty surrounding 'standard' buy-sell agreements, many specialists in this area structure the contractual arrangements using options.

The popularity of the put and call options is a response to the taxation concerns with mandatory buy-sell agreements and its two variations.[86] In contrast, in the US, mandatory buy-sell agreements remain popular, while option agreements are rare.[87]

Put and call options have four issues of concern that are now considered.

[82] This is if the option period in which to exercise the option has not expired and the parties have not rescinded or prejudiced their rights under the agreement containing the options.
[83] Further, the process of negotiating a different agreement could affect the validity and enforceability of the put and call options.
[84] Bobbin, above n 6, 7; see also Peter Bobbin, *Successful Succession: Planning for Success* (Taxation Institute of Australia, 26 August 1995) 11; Bernie O'Sullivan, *Estate & Business Succession Planning 2011–12* (Taxation Institute of Australia) 341.
[85] Burgess, above n 2, 13.
[86] See, generally, Bobbin, above n 84; Burgess, above n 2.
[87] AR Fantini, RA Esperti and RL Peterson, *Love, Money, Control: Reinventing Estate Planning* (Esperti Peterson Institute, 2004) 385.

(a) More Complex

As discussed above, mandatory buy-sell agreements are generally simpler and less expensive when compared to put and call options, which are conceptually harder to explain to clients.[88] Put and call options add additional complexity in both the drafting and explaining to clients.[89] If not for the issues with CGT timing, it is likely that mandatory buy-sell agreements would have remained the predominant succession planning structure in Australia, as they have in the US.

(b) Timing of the CGT Event

As with mandatory buy-sell agreements, a question for put and call options arises as to the deemed timing of the CGT event. This relates to the transfer of the outgoing owner's business interest for CGT event A1. Pursuant to *ITAA 1997* section 104-10, the timing can be either when the put and call option agreement is signed or when it is exercised. While options are specifically listed as CGT assets in the note to *ITAA 1997* section 108-5, they are not defined in the taxation legislation.[90] The Full Federal Court in *FCT v Guy*[91] considered, for the purposes of CGT, the concept of a grant of an option.[92] Their Honours stated that an option was 'a right in one party unilaterally to require another party to enter a new set of jural relations'.[93] The grant of an option is dealt with under CGT event D2, where *ITAA 1997* section 104-40 states in part:[94]

> (1) CGT event D2 happens if you grant an option to an entity …
>
> (2) The time of the event is when you grant … the option.
>
> (3) You make a capital gain if the capital proceeds from the grant, renewal or extension of the option are more than the expenditure you incurred to grant, renew or extend it.

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[88] Davies and McEwan, above n 3, 33.
[89] Ibid.
[90] In *ITAA 1997* s 108-5, CGT assets are given as:
> (1) A CGT asset is:
> (a) any kind of property; or
> (b) a legal or equitable right that is not property.
> (2) To avoid doubt, these are CGT assets ... Note 1: Examples of CGT assets are: ... options.

[91] (1996) 67 FCR 68; (1996) 137 ALR 193; (1996) 32 ATR 590; 96 ATC 4520.
[92] *ITAA 1936* s 160ZZC was considered, but this has since been replaced by *ITAA 1997* s 134-1.
[93] *FCT v Guy*, 96 ATC 4520, 4526, per Beaumont, Carr and Lindgren JJ.
[94] *ITAA 1997* s 104-40.

The timing of the put and call option depends on its construction. If the put and call option is subject to a condition precedent being a 'specified condition in the agreement that is yet to occur', such as death or disability, the option is only granted and acquired at the date of the satisfaction of a condition.[95] The ATO provided ID 2003/1190 dealing with options used in succession planning.[96] Taking this approach in ID 2003/1190, the Commissioner, concerning CGT event D2, stated that:[97]

> CGT event D2 does not occur at the time the [succession planning put and call option] agreement is entered into, but when the condition precedent to the grant (death or disablement of one of the shareholders) occurs.[98]

In summary, rather than the date that the option is signed, the transfer of a business interest is potentially the time when the option is exercised.[99] However, this depends on how the agreement is structured.[100]

(c) Value of the Option for CGT Purposes

As a put and call option is a separate capital gains asset, a third issue is whether the grant of an option in itself results in a capital gain for CGT purposes.[101] The amount of the capital gain would be the net value of the option granted.[102] This is consideration received for the granting of the option, or its market value, minus the cost of creating the option.[103] The option's value, if any, is lessened because it is not known whether any

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[95] ATO, *Capital Gains Tax—Business Succession Agreement—Put and Call Options—CGT Event D2*, ID 2003/1190, 30 June 2003, 2.
[96] See also ATO, *Capital Gains Tax—Date of Acquisition of Shares—Exercise of Options Acquired under Employee Share Schemes*, ID 2003/128, 14 January 2003.
[97] As the title of the ruling states, the ruling is only for the purposes of 'Capital Gains Tax—Business Succession Agreement—Put and Call Options'.
[98] ATO ID 2003/1190. The Commissioner takes the same approach, generally, as to succession planning agreements concerning condition precedents in ATO ID 2004/668.
[99] Craig McKie, *Business Succession Planning* (Taxation Institute of Australia , 28 February 2008) 7; see also Michael Flynn and Miranda Stewart, *Death & Taxes: Tax-effective Estate Planning* (Thomson Reuters, 5th ed, 2012) 151.
[100] See Michael Chow, *Australian Master Tax Guide* (CCHG, 49th ed, 2011) 511; and Sorbello et al., above n 9, 15, who stated that 'If an option is exercised to transfer a business interest, the time of transfer for CGT purposes will be when the option is exercised'. This also remains the Commissioner's position, as demonstrated, for example, in CGT Determination Number 13.
[101] See Sorbello et al., above n 9, 7.
[102] The usual cost base rules apply; for example, the option fee and incidental costs (such as legal fees, transfer and stamp duty) are included in the cost base.
[103] Lance Cunningham and Lucas Keegan, 'CGT Aspects of Business Succession Planning' *CGT Planning News* (Online, CCH Australia, 22 April 2005) ¶348.

owner's put or call option will be exercisable. This is on the basis that death and disability are generally unforseen events.

In *Carter v Hyde*, the High Court held that the value of an option could be referenced to its transferable value.[104] The succession plan is between the owners with the intention to ensure that the business stays with the remaining owners. Therefore, the option would not generally be assignable. The Commissioner in ID 2003/1190 stated that 'the options cannot be assigned'.[105] The option lacks a potential market.[106] The ATO discussion paper also stated that 'the market value of a promise to insure (as an asset held or an obligation undertaken) is negligible, if not nil'.[107] Further, as each owner both grants and receives options, there is potentially no net capital gain at the time of granting the option, as 'the market value of that option is likely to have a nil value'.[108] Finally, if the exercise price of the option is the market value of the owner's interest at the date an option is exercised, then there is generally little or no capital gain from the grant of the put and call option.[109] Few CGT consequences, therefore, arise from entering into a succession planning agreement structured through put and call options.

Rather, the event that gives rise to a possible CGT liability is when the option is exercised. This is a disposal of a CGT asset, under CGT event A1.[110] The date of the disposal is the date on which the option is exercised.[111] The tax impost is determined by reference to the cost base of the interest in the business and any valuation of the business interest utilised in its disposal.[112] This is further considered in Chapter Six.

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[104] [1923] HCA 36; (1923) 33 CLR 115.
[105] ATO ID 2003/1190, 2.
[106] Higgins J in *Carter v Hyde* [1923] HCA 36; (1923) 33 CLR 115, 38, citing with approval, Romilly MR in *Buckland v Papillon* (1866) LR 1 Eq 477, 479, where Higgins J decided that '[t]he option, the Master of the Rolls said, is part of the interest contained in the agreement; and it could be assigned by the assignee unless an intention to the contrary can be collected from the contents of the agreement itself'; and, 480, 'no one denies that an option may be so framed as to limit its exercise to the holder of the option in person'.
[107] Sorbello et al., above n 9, 9.
[108] McKie, above n 99, 7.
[109] The ATO discussion paper assumes that the market value is the option exercise price, and as set out in Chapter One, Part B: Scope, the research makes this assumption. See Sorbello et al., above n 9, 2.
[110] *ITAA 1997* s 104-5.
[111] Cunningham and Keegan, above n 103.
[112] The cost base issue creates its own unique problems in succession planning, as discussed in Chapter Six.

(d) Enforcing an Option Against a Deceased Estate

Where the principal owns the business interest directly, at death, the business interest forms part of the principal's estate.[113] In that case, the succession planning agreement needs to be enforceable as against the outgoing owner's executor or administrator.

If the outgoing owner owns the life insurance policy, then the insurance company pays the proceeds directly to the estate.[114] If the estate is not bound by the succession agreement, then the executor or administrator, with a fiduciary obligation to protect and maximise the value of the estate, may seek further payment from the remaining owners in exchange for the business interest.

Alternatively, where the insurance is cross-owned, so that the remaining owners hold the life insurance policy, then the insurance company pays the proceeds to the remaining owners.[115] While the remaining owners may exercise their call option and be willing to provide the insurance proceeds to the estate, the executor or administrator may decide to ignore the remaining owners' exercise of the call option, choosing instead to retain the business interest. In *Carter v Hyde*,[116] Knox CJ stated that, 'if the option is personal to the offeree ... it can, of course be accepted only during his lifetime and lapses at death'.[117]

Lucke stated that '[a]lthough options are rather special contractual arrangements, they seem to be subject to the usual canons of construction'.[118] Enforcement, by the remaining owners, through the courts under contract law is only possible if the estate is bound by the terms of the succession planning agreement.

This issue of whether options bind executors and administrators was addressed by the High Court in *Ballas v Theophilos.*[119] In this case, the succession planning agreement

[113] In this instance, the outgoing principal and outgoing owner is the same person.
[114] The 'self-ownership' model of holding the insurance is considered in Chapter Six.
[115] The cross-owned insurance model is discussed in Chapter Six.
[116] [1923] HCA 36; (1923) 33 CLR 115.
[117] The court upheld and relied on the decision in *Hyde v Skinner* [1723] EngR 23; (1723) 2 P Wms 196.
[118] HK Lucke, 'Options' (1968) 3 *The Adelaide Law Review* 2, 197, 197.
[119] [1957] HCA 90; (1958) 98 CLR 193.

gave the remaining owner (of the two-partner partnership) a call option to acquire the deceased outgoing owner's interest in the business. The option stated:[120]

> If either partner shall die during the continuance of the partnership ... then the surviving ... partner shall have the option of purchasing the share of the deceased partner in the capital and assets of the business.

The deceased's wife, as executor, argued that the option expired at death. The court decided that the option was effective after the outgoing principal's death. In that case, Williams J stated 'its effective exercise requires that it should be binding upon the executor, executrix or personal representative of the deceased partner'.[121] Thus, put and call options must be structured correctly to bind the outgoing owner's deceased estate.

D. Conclusion as to the Quest for Certainty as to Timing

A mandatory buy-sell agreement provides certainty in the succession planning process.[122] The structure is easier to explain to clients when compared to the other ways of structuring the succession plan. 'Agreements to agree', condition precedents and the put and call option structures add further complexity.[123] As discussed in Chapter Two, few commentators now recommend mandatory buy-sell agreements. In contrast, the mandatory buy-sell agreement has remained popular in the US.[124] For the reasons stated above, the Government should consider a CGT carve out for mandatory buy-sell agreements, so that the time of CGT event A1 for a succession plan is the time of the outgoing principal's death or disability.

CGT is a broad-brush tax. There was little specific consideration given for succession planning in small business. However, the Government does consider CGT relief for specific circumstances. For example, it has given taxpayers the choice as to whether to

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[120] Ibid 198.
[121] Ibid 208. See also *Goldsbrough, Mort & Co. Ltd. v Quinn* [1910] HCA 20; (1910) 10 CLR 674; *Carter v Hyde* [1923] HCA 36; (1923) 33 CLR 115; *Commissioner of Taxes (Qld) v Camphin* [1937] HCA 30; (1937) 57 CLR 127; *Trustees Executors & Agency Co Ltd v FCT* [1944] HCA 20; (1944) 69 CLR 270; *Sharp v Union Trustee Co. of Australia Ltd* [1944] HCA 35; (1944) 69 CLR 539; *O'Neill v O'Connell* [1946] HCA 59; (1946) 72 CLR 101; *Cavallari v Premier Refrigeration Co. Pty Ltd* [1952] HCA 26; (1952) 85 CLR 20 and *MacDonald v Robins* [1954] HCA 5; (1954) 90 CLR 515.
[122] However, generally, as to commercial contracts, it is open for the parties to the agreement if they all agree to vary the terms of agreement or rescind the agreement.
[123] Davies and McEwan, above n 3, 33.
[124] See generally Fantini, Esperti and Peterson, above n 87.

claim water-entitlement rollover relief to CGT events occurring in the 2005/2006 and later income years, as backdated from 2010.[125] More recently, the Government considered ameliorating the effects of CGT on a business merger involving the CGT rollover rules.[126]

Similarly, based on the taxation benchmarks, there should be a carve out for succession planning structures to enable owners to again have the use of the mandatory buy-sell structure without CGT ambiguity. This is so that there is certainty as to the timing of the agreement, being the principal's death or disability.

A significant difference in the US is that there are few practical or taxation restrictions on using mandatory buy-sell agreements. There are no value crystallisation issues such as those caused by *ITAA 1997* section 104-10, as discussed above. Mandatory buy-sell agreements, therefore, remain popular in the US.[127]

[125] *Tax Laws Amendment (2010 Measures No. 4) Bill 2010*.
[126] Amendments to the scrip rules were introduced as part of the *Tax Laws Amendment (2010 Measures No. 4) Bill 2010* on 23 June 2010. See, generally, CCH Tax Editors, *Australian Federal Tax Reporter* (CCH Australia Ltd, Daily Online Update) [161-405, 161-406]. Other CGT carve outs in the *ITAA 1997* (unless otherwise stated) include motor vehicles and motor cycles (s 118-5), decorations for valour (s 118-5), collectables costing $500 or less (s 118-10), certain personal use assets (s 118-10(3)), assets used to produce exempt income (s 118-12), shares in a PDF (s 118-13), compensation or damages for personal wrong or injury (s 118-37), compensation received under the firearms surrender arrangements (s 118-37), a re-establishment grant or a dairy exit payment under the *Farm Household Support Act 1992* (s 118-37), a sugar industry exit grant under the Sugar Industry Reform Program (s 118-37), winnings or losses from gambling, a game or a competition with prizes (s 118-37) and a tobacco industry exit grant received under the Tobacco Growers Adjustment Assistance Programme 2006 (s 118-37), certain rights and interests in insurance policies (s 118-300), units in a PST (s 118-350), entitlements under the financial claims scheme (sub-div 253-A) and venture capital investments (sub-div 118-F).
[127] See generally, Fantini, Esperti and Peterson, above n 87.

CHAPTER FIVE: DIFFICULTIES FACED BY THE ATO WITH INSURANCE FOR SUCCESSION PLANNING[1]

> 'The "road block" … is ensuring that the tax advice and legal documentation [for business succession planning] aligns with the client's objectives … [T]he tax and legal issues will require compromise.'[2]

A. Introduction

The research considers the need for reform in business succession planning. The issue of greatest concern in Chapter Four is the ambiguity of the timing of the business succession planning agreement for CGT events. This chapter moves from the succession planning structure to the funding of that succession planning structure using insurance. In particular:

1 While one owner is not entitled to claim a deduction for the insurance premiums but is taxed on the proceeds, another owner is able to obtain both a tax deduction and the proceeds tax-free. This offends neutrality when tested against the taxation benchmarks of efficiency, and equity and fairness. It was a recommendation of the Asprey Report that when there is a move away from neutrality there needs to be justification.

2 Pincus and White state that the 'courts have struggled to bring a desirable level of coherence to this area'.[3] The taxation of the insurance and the ATO's struggle to cope with the ambiguous legislation as evidenced by arbitrary changes in its position are considered.

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[1] The term 'struggle' used in this context is taken from CW Pincus and Steven White, 'Taxation of Compensatory Payments and Judgments' (2001) 75 *Australian Law Journal* 378, 378.

[2] Matthew Burgess, *Passing Control of a Business on Insurable Events—Ensuring Fair Outcomes* (Taxation Institute of Australia, 18th National Tax Retreat Taxation Institute of Australia, Sheraton Noosa Resort & Spa, Noosa, 19 August 2010) 15.

[3] Pincus and White, above n 1, 378.

3 Justification for an emphasis on the regulator's position, and not just the legislation, is based on small businesses often not having the resources to challenge a position taken by the ATO. The ATO pronouncements, therefore, can take on a quasi-legislative quality, especially because both private and public rulings are binding on the ATO.[4] While rulings are not binding on the courts, where the taxpayer has followed the ruling, the ATO will not impose penalties.

4 A favourable CGT exemption on the insurance proceeds is restricted to life insurance, and does not include TPD and trauma. Further, the exemption requirements for all three insurances are so ambiguous as to be unworkable. It is argued that this offends the taxation benchmark dealing with equity and fairness.

The three types of succession planning insurance—being life, TPD and trauma—provide compensation at the time of the principal's death or disability.[5] The insurance proceeds, depending on their intended purpose and on how they are structured, may be non-assessable or assessed as ordinary income or a capital gain. In the High Court case of *Carapark Holdings v Commissioner of Taxation* ('*Carapark*'), the company took out life insurance policies on the employees of its subsidiary.[6] When one of the employees died, the policy proceeds were used to establish a trust for his widow and children. The court held that the proceeds were assessable income of the holding company. Fullagar J stated:[7]

> In general, insurance moneys are to be considered as received on revenue account where the purpose of the insurance was to fill the place of a revenue receipt, which the event insured against has prevented from arising.

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[4] However, they are not binding on the taxpayer. This has been the case since 1992, pursuant to *Taxation Administration Act 1953* s 357-60.
[5] The nature of such insurances is discussed in Chapter Three.
[6] (1966) 115 CLR 653; (1967) 14 ATD 402.
[7] Ibid 663.

This is based on the 'replacement principle'.[8] For this principal, if the item being insured is assessable as income then the proceeds of the insurance that replace the item are also assessable as income.[9]

Applying the replacement principal, the Administrative Appeals Tribunal case of *Barnett v FCT* considered whether a lump sum compensation payment was income or capital. Senior Member Block stated that:[10]

> Where an employer wrongfully terminates an employment contract an employee may suffer earnings loss, but his earning capacity is unimpaired. By contrast, personal injuries impair the earning capacity. The decisions in *Atlas Tiles* and *Cullen v Trappell* firmly establish the principle that compensation for wage loss resulting from injury is not assessable. Nor is this principle an exception to the replacement principle, if the wage loss is viewed as impairment of earning capacity, being a capital asset (but not a capital asset for the purposes of Part IIIA).[11]

What is a struggle for the court is also a struggle for the taxation regulator—the ATO.[12] The Commissioner updated the ATO's position to comply with *Carapark* in Taxation Ruling IT 155.[13] Chow stated that 'it would follow that if the purpose is to insure against the possibility of a capital loss, the premiums will normally be treated as non-deductible and the proceeds will not normally be assessable'.[14] However, this is not necessarily the case in succession planning because, as considered over the following two chapters, it is possible for the insurance premiums to be not deductible and the proceeds subject to taxation.[15] For example, citing *Federal Commissioner of Tax v Myer Emporium*[16] as the authority, the ATO discussion paper stated:[17]

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[8] Pincus and White, above n 1, 379.
[9] The decision in the *Carapark* case also demonstrates that the application of the replacement principle does not have to be direct, as, on the facts, a certain amount of separation between the taxpayer, a holding company and the employee of a subsidiary company existed.
[10] 99 ATC 2444[2458]; cf *Gillespie v FCT* (2002) ATC 2006, [2001] AATA 1009.
[11] *Atlas Tiles v Briers* [1976] 144 CLR 202 (High Court); *Cullen v Trappell* [1979] 146 CLR 1 (High Court).
[12] Pincus and White, above n 1, 378.
[13] ATO, *Key Man Insurance—Assessability of Proceeds and Deductibility of Premiums*, IT 155, 28 June 1968, 1[2], where the Commissioner stated, concerning the *Carapark* case, that 'a new test would have to be substituted for the one normally applied in determining such questions'.
[14] Michael Chow (ed), '"Key Man" Insurance Premiums, *1999 Australian Master Tax Guide* [14-570].
[15] See Chapters Five and Six of this research.
[16] (1987) 18 ATR 693.

> While payments or insurance proceeds used to fund a buy-sell agreement will ordinarily be capital in nature, there may be circumstances in which they will be so linked to the business or profit-making activities of the taxpayer as to form part of the income of that taxpayer.

To highlight the above issues, the chapter is divided into three sections: the deductibility on the insurance premiums, the income tax payable on the insurance proceeds and, finally, CGT on the insurance generally.[18]

B. Deductibility of the Business Succession Planning Insurance Premiums

The taxation benchmark of equity and fairness is not achieved for the deductibility of the insurance premiums. There are different taxation treatments between the insurances, with trauma being treated differently from life and TPD. Further, there is different taxation treatment of the insurances based on either whether they are held within or external to a superannuation fund. To demonstrate the need for reform, this part of the chapter is divided into four sections: (1) life and TPD insurance held externally to a superannuation fund; (2) life and TPD insurance within a superannuation fund; (3) trauma insurance within a superannuation fund; and (4) trauma insurance held externally to a superannuation fund.

1 Life and TPD Insurance Held Externally to a Superannuation Fund

ITAA 1997 section 8-1 provides for those amounts which constitute deductions.[19] The general approach the courts take to an insurance premium is that, where the policy provides for payment to the insured of an amount that constitutes assessable income, the

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[17] S Sorbello et al., *Discussion Paper in Relation to Buy-Sell (Business Succession) Agreements* (ATO, 2000) <http://civiclegal.com.au/Publications/3051ATODiscussionPaper-BuySell.pdf> 1.

[18] From the perspective of the insurance company as taxpayer (rather than policyholder), ATO, *Income Tax—Life Insurance Company: Assessment of Premiums 'Paid' to the Company*, ID 2007/41, 25 January 2007 considers the issue of when premiums are 'paid to' a life company and, accordingly, when they are included in the life company's assessable income.

[19] *ITAA 1997* s 8-1 states that:

> (1) You can deduct from your assessable income any loss or outgoing to the extent that:
>
> (a) it is incurred in gaining or producing your assessable income; or
>
> (b) it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income.
>
> (2) However, you cannot deduct a loss or outgoing under this section to the extent that:
>
> (a) it is a loss or outgoing of capital, or of a capital nature.

See also Robin Woellner et al., *Australian Taxation Law* (CCH Australia Ltd, 21st ed, 2011) 520 [10-000].

premium is deductible.[20] Generally, whether an insurance premium is deductible depends on the purpose for which the insurance was acquired. In succession planning, insurance proceeds are generally a payment on capital account. Hely J stated in *FCT v La Rosa* ('*La Rosa*'):[21]

> Whether the occasion for a loss or outgoing lies in business operations so as to be deductible under *ITAA 1936* section 51(1) requires a judgment about the nexus between the loss or outgoing and the business operations. As a general rule, if there is that proximity then the loss or outgoing is deductible by force of the statute unless the loss or outgoing is of capital or of a capital nature.[22]

The ATO uses the *La Rosa* decision to justify its position that insurance premiums paid for the purposes of succession planning are not deductible.[23] However, in *Federal Commissioner of Tax v Smith* ('*Smith*'), the High Court stated that insurance proceeds received during a period of total disability by the taxpayer were of a revenue character. The majority in that case held that:[24]

> It is true that the payment of the [insurance] premium … did not result in the generation of any income in that year, but there is a sufficient connection between the purchase of the cover against the loss of ability to earn and the consequent earning of assessable income to bring the premium within the first limb of *ITAA 1936* section 51(1). Likewise, the periodic nature of the payment and other provisions in the policy which contemplate its renewal from year to year militate against its characterization as an outgoing of a capital nature.

In *Smith*, the court decided that, while the likelihood of the insurance premiums creating income may not be certain, it was still sufficiently connected to the business of creating income to be deductible. The ATO extended this approach in Interpretive Decision ID 2010/178, stating that where the insurance is used for income protection (rather than succession planning) the premiums are sufficiently 'incidental and relevant to the

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[20] Ibid.
[21] (2003) 198 ALR 521, 521.
[22] For the 1997/1998 and later financial years, *ITAA 1936* s 51(1) was replaced by *ITAA 1997* s 8-1.
[23] See, for example, ATO, *Income Tax—Deductibility of Income Protection Premiums*, ID 2010/178, 18 August 2010.
[24] 81 ATC 4114, (1981) 11 ATR 538, (1981) 147 CLR 578, (1981) 34, ALR 16, 20. This case cites as authority *Charles Moore & Co (WA) Pty Ltd v FCT* (1956) 95 CLR 344, 351. See also *Ronphibon Tin NL v FCT* (1949) 78 CLR 47, (1949) 8 ATD 431.

operations and activities to produce assessable income'.[25] In succession planning, the proceeds of insurance are usually received as a lump sum, whereas in *Smith* the proceeds were paid periodically. *Smith* demonstrates that, depending on its purpose, the proceeds of such insurances can be on revenue account. However, there are inconsistencies because the purpose of the insurance is not always relevant in deciding whether insurance premiums are on income or capital account.

The insurance's purpose is sometimes not considered by the Commissioner to be decisive in ascertaining whether the premiums are on the income or capital account. For example, ATO Interpretive Decision ID 2004/661 deals with mortgage protection insurance used to protect non-business loans.[26] This would include a main residence mortgage.[27] According to ID 2004/661, such premiums are deductible and any proceeds are subject to income tax. Making payments on a taxpayer's main residence mortgage (the insurance's purpose) is, according to ID 2004/661, not of a 'capital, private or domestic nature'.[28] However, the interest paid on a main residence mortgage is not generally deductible.[29] As stated in ATO private binding ruling PR 94264, 'in determining whether an interest expense is deductible or not, we consider the purpose to which the borrowing is applied when the interest arises'.[30] The ATO does not necessarily always treat the purpose of the insurance as decisive to whether the insurance premiums are on income or capital account.

Another example of an inconsistency with the ATO's approach is from a comparison of Taxation Rulings IT 2678 and 2504.[31] These rulings relate to whether interest charged

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[25] ATO ID 2010/178, 2; see also ATO, *Income Tax—Deductions: Premium Incurred for the Disability Cover under a Mortgage Protection Policy*, ID 2004/661, 3 June 2004, which concerns the deductibility of insurance used as a mortgage protection policy, and ATO *Income Tax: Deductibility of Interest on Borrowed Funds—Life Assurance Policies*, IT 2504, 3 November 1988, 2, which stated in respect of *Smith's* case:

> while it is not necessary that an outgoing actually result in production of assessable income in the year in which it is incurred, there must still be a connection between the expenditure and the 'operations which more directly gain or produce the assessable income.

[26] The type of insurance in ATO ID 2004/661 was restricted to disability insurance, rather than life insurance.

[27] For the CGT main residence exemption, see *ITAA 1936* s 118-110. ATO ID 2004/661 related to a 'housing loan' that, while undefined in the ID, would include a main residence such as a 'family home'.

[28] ATO ID 2004/661, 2.

[29] This is assuming that the residence is not used for income producing purposes, and was not acquired or built for profit-making purposes.

[30] ATO, *Expenses—Investments—Travel*, PR 94264, 30 November 2009 <http://www.ato.gov.au/printfriendly.aspx?doc=/rba/content/94264.htm> 2.

[31] ATO, *Income Tax: Deductibility of Interest on Money Borrowed to Make Superannuation Contributions*, IT 2678, 14 May 1992 was withdrawn on 21 February 2007, see ATO IT 2678W—*Notice of Withdrawal*.

on borrowed money is deductible in different circumstances. In IT 2678, the ATO stated that the interest charged on money borrowed by an employee to contribute to his or her superannuation fund is deductible. The ATO argued that this was because the contribution 'bears the character of an outgoing incurred in gaining or producing assessable income'.[32] In addition, it is 'an investment to secure rights under the fund'.[33] However, the sole purpose of a member's superannuation fund, while it is used as an 'investment' vehicle, is for the private matter of a member's retirement.[34] Further, if the member is in retirement phase and takes a pension, then there may be no tax paid on the superannuation or the money derived from any investments in the superannuation fund.[35]

In contrast, IT 2504 stated that a taxpayer could not claim the interest for money borrowed to buy life insurance because:[36]

> (i) the interest is not incurred in gaining or producing assessable income because any connection … is too remote; and
>
> (ii) expenditure related to a life assurance policy ... is of a private nature.

However, superannuation assets do not necessarily lead to, in the words of IT 2504, 'assessable income'.[37] As stated above, there may be no 'assessable income' payable by the superannuation fund.

Both IT 2504 (deductibility of interest on moneys borrowed to fund insurance premiums) and IT 2678 (deductibility of interest on borrowings to contribute to a superannuation fund) can have the same purpose of protecting a similar class of people. In the words of IT 2678, these are 'dependants', such as the insured member's family.[38]

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[32] Ibid., [11], citing as authority *Fletcher v FCT* 91 ATC.
[33] Ibid., [15].
[34] The issue of 'sole purpose' is considered in Chapter Six.
[35] For a superannuation fund in the pension phase—that is, paying current pensions—the exemption provisions in the *ITAA 1997* are: (1) exempt current pension income, ss 295-385, 295-390; and (2) disregarding capital gains and capital losses, ss 118-12, 118-320.
[36] ATO IT 2678 [17], quoting from ATO IT 2504 [19].
[37] ATO IT 2504.
[38] For superannuation purposes, 'dependants' are persons to whom a superannuation benefit can be paid upon a member's death. A person is a 'dependant' due to their relationship to the member (husband, wife, *de facto* spouse, child, including adult child and adopted child) or because the person is financially dependent on the member: *Superannuation Industry (Supervision) Act 1993* (Cth) s 10.

However, while the purposes are the same, the taxation implications are different. Each IT reaches different conclusions. The Commissioner in IT 2504 contends that life insurance is of a 'private nature',[39] because life insurance 'is a method by which a person can provide benefits for dependants or others on that person's death'. Superannuation, in contradiction to IT 2678, is also arguably of a 'private nature'.[40] When read together, it is difficult to reconcile the ATO's approach to the replacement principle.

To help apply the legislation and cases dealing with whether succession planning insurance premiums can be deductible, an analogy is drawn from how the law treats the deductibility of interest payable by a taxpayer in certain circumstances. In the High Court decision in *Steele v FCT* (*Steele's* case), Mrs Steele, in 1980, purchased a property with the intention to build a motel on it.[41] From 1980 to 1987, despite her intentions, no motel was erected.[42] A question was whether interest on the loan to acquire the property was deductible. Much like the potentially large gap in time between the payment of insurance premiums and a potential payout, similarly for Steele, she incurred the expense of the interest in financial years before the motel was ever to be built. The court held that the interest was not a capital expense because no assessable income was derived in the relevant year.[43] The expense and the producing of income did not need to occur in the same financial year. The court decided that the interest was deductible. This suggests the possibility of moneys borrowed to buy life insurance also being deductible. However, the deduction is expressly disallowed under *ITAA 1997* section 26-85, unless the proceeds form part of the taxpayer's assessable income. In contrast, deductions for interest and borrowing costs connected with a contribution are generally deductible.[44]

The ATO's position, based on the consideration of the insurance's purpose, is that insurance premiums used for succession planning are not deductible under *ITAA 1997* section 8-1. The insurance has the purpose of replacing capital, being the ownership of the business. However, in light of ID 2004/661 and other ATO statements, there would

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[39] ATO IT 2504 [12].
[40] Cf *Case Y20 91* ATC 243; ATO IT 2504.
[41] 97 ATC 4239; 99 ATC 4242; (1999) 41 ATR 139.
[42] Mrs Steele only received a small amount of agistment income.
[43] However, preliminary expenses on feasibility studies may not be deductible. See generally, *Softwood Pulp & Paper case* 76 ATC 4439.
[44] See sub-div 290-B generally, and specifically see *ITAA 1997* s 26-80.

appear to be inconsistent reasoning by the ATO as to deductibility of insurance premiums. This is not in accordance with the taxation benchmark relating to simplicity. Legislation needs to be introduced that specifically deals with the deductibility of premiums of insurance when used for business succession planning to avoid such inconsistencies. Reform of the legislation is desirable to allow expressly for the insurance used in a succession plan to be deductible.[45]

2 Life and TPD Insurance Premiums in Superannuation: A Question of Discrimination?

The taxable income of a complying superannuation fund is determined as if the trustee were a taxpayer and an Australian resident.[46] *ITAA 1997* section 295-460 allows a superannuation fund to claim a deduction for insurance premiums paid towards a member's death benefit or 'disability superannuation benefit'.[47] Such deductibility is generally not possible when the insurance is held externally to a superannuation fund. A requirement set out in the taxation benchmark of equity and fairness is horizontal equity. This requires taxpayers in similar economic circumstances to be treated similarly.[48] For life and TPD insurance used in a succession plan, the taxation implications should be neutral and equitable between the different business structures holding the insurance. The owners' decision on how to structure the succession plan should be focused on economic rather than taxation issues. Business owners should be subject to similar levels of taxation. Yet, in contrast to life and TPD held externally to superannuation, in superannuation the same polices with the same purpose are deductible. Putting aside the taxation benchmark of equity and fairness, this does not accord with the standards relating to neutrality. However, as suggested in the Asprey Report, a departure from neutrality, in this instance being discrimination in favour of a superannuation structure, may be a justifiable distortion of the taxation system.[49]

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[45] Recommendations as to legislative reform are suggested in Chapter Seven.
[46] *ITAA 1936*, s 272.
[47] The relevant section of *ITAA 1997* s 995-1 is as follows: 'gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training'. As to s 295-460, for the 2007/2008 and later financial years, the provision that replaced *ITAA 1997* s 279 was *ITAA 1997* (Act 15 of 2007) s 295-460.
[48] See Chapter One.
[49] Taxation Review Committee (Kenneth William Asprey, Chair), *Full Report* (AGPS, Canberra, 1975) (Asprey Report) [7.94]; also see the discussion of the taxation benchmark contained in Chapter One.

The Asprey Report specifically considered such a 'justification' for superannuation. The report stated that:[50]

> For the deduction of contributions to a superannuation fund ... it is reasonable to allow the postponement of tax on income when expenditure of that income has been demonstrably deferred, provided there is some assurance that it will be brought to tax at a later time'.

The justification is weakened because, since the report was written, the laws have changed. Now, upon the member's retirement, both the superannuation pension payments and income earned in the superannuation fund may be tax-free.[51] Such payments and income may never be 'brought to tax at a later time'.[52] The succession planning insurance in the superannuation fund has the same purpose as the insurance outside the superannuation fund— to fund a succession plan. The justification as to why insurance in superannuation should be treated more favourably to allow for such a departure from neutrality is not sustainable.

In Taxation Determination TD 98/27, the ATO took the view that not only life insurance but also TPD insurance was fully deductible when purchased by a superannuation fund. It stated that:[53]

> A deduction is allowed under [*ITAA 1936*] section 279 for a complying superannuation fund for so much of any insurance premiums paid as is attributable to the provision of death and disability benefits for the members of the fund.[54]

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[50] Ibid.
[51] This is subject to the age of the member, where:

- at age 60 or more, the whole benefit is not assessable income and not exempt income, and is therefore tax-free: *ITAA 1997* s 301-10;
- under age 60 but over the preservation age of 55 (or more, depending on date of birth), there is a tax-free component: *ITAA 1997* s 301-15;
- under age 60 but over the preservation age, the taxable component is assessable income, with a 15 per cent tax offset: *ITAA 1997* s 301-25; and
- under preservation age, there is a tax-free component, but the taxable component is assessable income; the 15 per cent tax offset is only available for disability superannuation benefits: *ITAA 1997* ss 301-30 and 301-40.

[52] Asprey Report, above n 49, [7.94].
[53] ATO, *Income Tax: Is a Deduction Allowable to Complying Superannuation Funds Under Section 279 of the Income Tax Assessment Act 1936, for Insurance Premiums Attributable to the Provision of Benefits for Members in the Event of Temporary Disability Longer than Two Years?* TD 98/27.

Both before and after this Determination there was, according to Merriman, a 'widespread view across the industry ... that premiums paid by a superannuation fund trustee for any typical TPD cover on a fund member would be deductible'.[55] This was the case even though (total and) 'permanent disability' was not defined in the *ITAA 1936*.[56]

In 2008, the ATO cast doubt as to whether TPD premiums were fully deductible when paid by a superannuation fund. ATO National Tax Liaison Group Superannuation Technical Sub-group minutes 31 March 2008 Agenda Item 9.5 stated:[57]

> Under the *ITAA 1936* provisions relating to deductibility of insurance premiums, premiums for TPD cover were deductible to a superannuation fund if they were in respect of policies that provided benefits to a member in the event of their permanent disability (*ITAA 1936* sections 267 and 279).[58] Permanent disability was not defined in the *ITAA 1936* and many providers in the industry interpreted it as covering a range of different TPD definitions.
>
> The new *ITAA 1997* provisions that address deductibility of insurance premium expenses for complying superannuation funds are intended to reflect those *ITAA 1936* provisions so that outcomes would not change. … However, under the new provisions, the ability for a fund to deduct insurance premiums for TPD benefits depends as to whether the premiums are in respect of insurance policies that provide disability superannuation benefits (*ITAA 1997* sections 295-460 and 295-465). The new legislation (section 995-1(1)) very specifically defines disability superannuation benefits.

The Explanatory Memorandum to the amendments of the *Tax Laws Amendment (Simplified Superannuation) Act 2007* stated that the 'rewritten provisions in *ITAA 1997*

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[54] For the 2007/2008 and later financial years, the provision that replaced *ITAA 1936* s 279 was *ITAA 1997* s 295-460 (Act 15 of 2007).

[55] Sue Merriman, 'Deductible Disability Cover', *Asset* (Financial Review, 2011) 36–37; Sorbello, above n 17.

[56] Merriman, above n 55, 36.

[57] In ATO National Tax Liasion Group, Superannuation Technical Sub-group minutes (31 March 2008) Agenda Item 9.5, commentators suggested how TPD should be treated:

> We seek confirmation from the Tax Office that the new provisions will be administered in line with the previous law, that is, it will not be necessary for the TPD definitions to be aligned with the definition of disability superannuation benefit in order for the fund to be able to claim the premiums as a deduction.

[58] For the 2007/2008 and later financial years, the provision that replaced *ITAA 1997* s 279 was *ITAA 1997* s 295-460, and *ITAA 1936* s 267 was replaced by *ITAA 1997* s 995-1, which contains the definitions used for tax purposes (*Act 15 of 2007*).

Division 295 do not change the law as it currently operates under Part IX of the *ITAA 1936*'.[59] Yet, two years later, the ATO's position changed in Draft Taxation Determination TD 2010/D9.[60] There seems to be no justification for the ATO's changed position[61] other than its mandate to raise revenue.[62]

According to *Wade v FCT*, it may be difficult to estop the ATO from recanting from an earlier, more favourable to the taxpayer, ruling.[63] However, most rulings are, at the taxpayer's option, prospective, as adverse new rulings can be ignored if the taxpayer had acted in accordance with the previous ruling and put in place the scheme before the previous ruling was altered or withdrawn.[64]

Since the ATO's changed position, premiums paid for TPD through superannuation may not be fully deductible.[65] The deductibility turns on the degree of certainty of the TPD insurance payout being a 'disability superannuation benefit'. This is where the member can no longer be 'gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training'.[66] This is tested against the terms of the TPD insurance policy. A full deduction is available if the TPD policy and 'disability superannuation benefits' are 'aligned'.[67] Failing such 'alignment',

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[59] Explanatory Memorandum, *Tax Laws Amendment (Simplified Superannuation) Act 2007* [3.1].

[60] The Tax Determination deals with ss 295-465(1) and 395-460(b). While it is usual practice for taxation rulings to be issued first in draft form for public comment, there is no actual requirement for the ATO to put out a draft ruling before issuing a finalised ruling. See ATO publication 'Public Rulings Manual Overview Kit' Stages 3–5, which specifically refers to the preparation, approval and release of a draft ruling. The ATO has the following comment on its website:

> **Consultation and feedback on public rulings—Draft rulings and determinations**
> Draft rulings and determinations are made available for public comment to seek professional, industry and community input on the ATO's proposed position on tax issues. The period for public comment is normally six weeks for a ruling and four weeks for a determination. This public consultation period is in addition to more targeted consultation that may occur during the development of a ruling or determination. … All persons making comments will receive a response to their comments soon after the final ruling is issued.

[61] The ATO's new position, as espoused in ATO, *Income Tax: Deductibility Under Subsection 295-465(1) of the Income Tax Assessment Act 1997 of Premiums Paid by a Complying Superannuation Fund for an Insurance Policy Providing Total and Permanent Disability Cover in Respect of its Members*, TR 2010/D9, was later legislated for by *Tax Laws Amendment (2011 Measures No. 4) Bill 2011*, which was passed by the Senate on 15 June 2011. See also generally the *Superannuation Legislation Amendment Act 2010*.

[62] *Review of Business Taxation, A Tax System Redesigned* (Ralph Review) (AGPS, Canberra) 104.

[63] (1951) 84 CLR 105.

[64] This grandfathering effect is from *ITAA 1997* ss 358-5 and 358-10(2), and this is considered in ATO, *Provision of Advice and Guidance by the Tax Office*, PS LA 2008/3.

[65] *The Tax Advisers' Voice* (National Tax & Accountants' Association, July 2011) 5–6.

[66] Ibid.

[67] This assumes the superannuation fund's trust deed provides for such a benefit. See generally Merriman, above n 55, 36.

only part of the premiums may be deductible.[68] Under *ITAA 1997* section 995-1(1), a 'disability superannuation benefit' is a superannuation benefit:

- that is paid to a person because he or she suffers from ill health (whether physical or mental), and

- because of the ill health, it is unlikely that the person can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

TPD covers two levels of business risks: 'own occupation' and 'any occupation',[69] specifically:

1. In 'own occupation', for the insurance company to pay out on the TPD policy, the principal only needs to show that he or she is unable to work in a particular stated occupation. The premiums for own occupation are, therefore, more expensive than 'any occupation', as they are easier to claim on.[70] Own occupation is 'usually reserved for professional and white collar occupations'.[71]

2. Conversely, for 'any occupation', the principal must satisfy the insurance company that he or she can no longer work in any position to which he or she is reasonably suited by 'education, training or experience'. This is a harder test for the principal to satisfy.

As stated above, for the insurance company to pay out for 'own occupation' TPD, the member of the superannuation fund needs to be unable to perform, as set out in the policy, within his or her own occupation. This is 'broader' than the definition of

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[68] An actuary's certificate is required for a premium that covers insured events. This is if there is uncertainty as to whether the events result in the fund being liable under the trust deed to provide the 'disability superannuation benefit' or if the superannuation fund can rely on specified proportions for deductions, as expressed by way of percentages under *Income Tax Assessment Regulations 2011 (No. 5)*, Regulation 295-465.01.

[69] A third type is 'home duties'. This is where the TPD insurance covers a person involved in domestic duties. This is not relevant to the research because of the lack of a nexus to a business enterprise.

[70] Phil Mileham, 'In a Nutshell: Critical Illness Cover' [2010] *General Practitioner*, 44, 44.

[71] 'Comparing the Cost of Purchasing Insurance within and outside of Superannuation', CCH Commentary (Australian Financial Planning Navigator) ¶7-065.

'disability superannuation benefit'.[72] While the member cannot engage in his or her own occupation, the member may still be able to find other gainful employment for which he or she is reasonably qualified by 'education, training or experience'.[73] A consequence of 'own occupation' failing to satisfy the 'disability superannuation benefit' is that the insurance payout is retained in the superannuation fund.[74] It does not relate wholly to the fund's liability to provide a 'disability superannuation benefit'. In that case, the premiums are no longer fully deductible.[75]

TPD needs to be 'own occupation', not 'any occupation'. A succession plan is based on a principal leaving the business when he or she can no longer work in the capacity of a principal in the specific business because of the disability. This is a specific requirement related to working in the particular business entity, rather than working in another capacity or in another enterprise.

In 'any occupation' TPD, the outgoing principal could suffer from a TPD and be no longer able to work in the business as a principal. However, the principal may not satisfy the TPD condition of payment if the principal could engage in other duties or work in another enterprise 'in a capacity for which he or she is reasonably qualified because of education, experience or training'.[76] Therefore, a succession plan requires 'own occupation' TPD insurance, rather than 'any occupation'. However, with no intended change to 'the law as it currently operates' and no intended change to the Government policy, such premiums, since 2010, are only partially deductible.[77]

A succession plan may be entered into many years before it comes into effect. The agreement is entered into based on the law at that time. As stated above, due to the possibility that small business may not have the funds or resources to challenge the ATO's interpretations of the taxation laws, the ATO's interpretations become quasi-

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[72] The use of the word 'broader' is derived from *The Tax Advisers' Voice*, above n 65, 5–6.
[73] *ITAA 1997* s 995-1.
[74] This is until a condition of release is satisfied such as reaching 65 years of age, having a terminal illness or suffering permanent incapacity.
[75] An actuary certificate is then required to state how much of the premium is attributable to the fund's liability to provide a 'disability superannuation benefit' and only this portion is deductible.
[76] *ITAA 1997* s 995-1.
[77] Explanatory Memorandum, *Tax Laws Amendment (Simplified Superannuation) Act 2007* [3.1]. The percentage of deductibility is as apportioned by an actuary, as considered above. However, at the taxpayer's option, with no actuary certificate, it is deductible as to 67 per cent: *Income Tax Assessment Regulations 2011 (No. 5)*, Regulation 295-465.01. For example, any occupation TPD is 100 per cent deductible, while own occupation TPD is 67 per cent deductible without an actuary certificate.

legislative. While there is a risk that the laws change due to changes to legislation and case law, the ATO changing its position, albeit because of ambiguous legislation, without changes to the law, puts an additional barrier to the creation of the succession plan. This offends the benchmark of efficiency and the encouragement of economic growth.

3 Trauma Insurance Held Externally to a Superannuation Fund

According to the Commissioner, premiums payable by an employee or a self-employed person towards his or her own trauma insurance are not deductible, as 'the policy does not replace earnings lost by the taxpayer'.[78] The ATO regards trauma insurance as being 'to provide a capital amount to the insured if the insured suffers a specified medical condition'.[79] Conversely, premiums paid by an employer for trauma insurance are generally deductible under *ITAA 1997* section 8-1, according to Taxation Determination TD 95/42, provided that the:[80]

(a) employer owns the policy;

(b) employer is the beneficiary of the policy;

(c) insurance is for revenue purposes; and

(d) the policy's purpose is to advance the employer's business ends.

Given the above requirements set by the ATO, trauma premiums for a succession plan are not deductible, as the insurance payout is not used for a revenue purpose. Rather, it is used as capital to purchase the outgoing owner's interest in the business. As stated in this chapter, insurance payouts received under a succession plan are presumed by the

[78] ATO, *Income Tax: Is a Premium Payable on a Trauma Insurance Policy by a Self-Employed Person or an Employee an Allowable Deduction to the Self-Employed Person or Employee?* TD 95/41, 9 August 1995.
[79] Ibid.
[80] ATO TD 95/42. The Determination dealt with *ITAA 1936* s 1(1), which was replaced by *ITAA 1997* s 8-1.

ATO to be paid for the capital purpose of transferring the equity in the business to the remaining business owners. As reasoned by the ATO:[81]

> A revenue purpose would exist where any benefit expected to be obtained by the employer under the policy was to cover the loss of profit, either on account of reduced income or increased expenditure, arising as a result of the loss of the employee through the occurrence of the insured event or condition under the trauma policy. There needs to be a nexus between the amount of the insurance benefit and the expected quantum of lost profits.

Therefore, under the legislation, and as argued by the Commissioner based on that legislation, trauma premiums are treated separately to life insurance and TPD and are not generally deductible when used to fund a succession plan.

4 Trauma Insurance Premiums—In Superannuation

In superannuation, the taxation of trauma premiums is different from life and TPD insurance. As considered above, the definitions of 'death' and 'disability' are relevant. According to the ATO, where trauma policies are purchased by a superannuation fund for its members, no tax deduction is available on the premiums. This is based on the Commissioner's view that trauma policies are not contemplated by *ITAA 1997* section 295-460, which deals with the deductions for premiums paid towards life and disability insurance (including TPD).[82]

This is not necessarily the case, because in ATO Interpretative Decision ID 2002/371, the ATO bases its legislative interpretation on the parties' motivations for taking out the trauma insurance.[83] The ATO has taken a narrow view of *ITAA 1997* section 295-460. Dr Barnard stated that a prime reason for trauma is to allow the patient to pay immediate treatment costs and ongoing living costs after recuperation.[84] 'Compensation' may not be the reason a taxpayer takes out a trauma policy, nor,

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[81] Ibid.
[82] ATO, *Superannuation—Part IX Taxation of Superannuation Entities—Superannuation Fund Expenses—Trauma Policy*, ID 2002/371, 9 September 2007.
[83] Ibid.
[84] This is as discussed in Chapter Three. See Marius Barnard, *Critical Illness Insurance: Past, Present and Future* <http://www.actuaries.org.uk/sites/all/files/documents/pdf/Barnard.pdf>.

correspondingly, why the proceeds are paid. The Commissioner's narrow approach as to purpose is not consistent with the ATO's view as to intention as set out above.

5 Conclusion as to Deductibility of Insurance Premiums

The ATO's reasoning, based on the purpose for which the insurance is used, cannot be consistently applied, as considered in light of ID 2004/661 and the other examples discussed above. It can lead to unfairness. Further, unfairness arises because the premiums for succession planning insurance are deductible in some structures, such as superannuation, and not deductible if held in other structures.

C. The Effect of Income Tax on the Insurance Proceeds

1 Introduction

The third section of this chapter considers issues on how income tax (not including CGT) applies to the proceeds of insurance used in succession planning. The CGT implications are considered in the third section of this chapter.

Pursuant to *ITAA 1997* section 6-5, assessable income includes ordinary income derived directly or indirectly from all sources.[85] While this includes income from rendering personal services, income from property and income from carrying on a business, the ATO has stated that it may also include receipts that:[86]

1. are earned
2. are expected
3. are relied upon, and
4. have an element of recurrence and regularity.

Potentially, insurance proceeds could be subject to income tax based on the ATO's above approach. For example, in response to point three, most insurance is 'relied upon'. However, only insurance proceeds representing lost income are generally treated as ordinary income.[87] Conversely, payments representing a loss of earning capacity (for

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[85] *ITAA 1997* s 6-5(1) states 'Your assessable income includes income according to ordinary concepts, which is called ordinary income'.
[86] ATO, *Income Tax CGT: Buy-Sell (Business Succession) Agreement—Life Insurance Proceeds—Income or Capital*, ID 2003/1189, 30 June 2003
[87] See *FCT v Smith* (1981) 34 ALR 16.

example, losing a limb) are treated as capital in nature and are potentially subject to CGT.[88] For succession planning, the distinction between a loss of income and a loss of earning capacity can be difficult to establish. The ATO specifically considered the classification of life insurance for succession planning purposes in Interpretative Decision ID 2003/1189 and asked itself the question: 'Are the proceeds from a life insurance policy, payable on the death of the insured person, assessable income under sections 6-5, 6-10, 15-30 *ITAA 1997*?'[89] In that ID, the ATO stated that the proceeds under a 'life policy' are neither ordinary income nor statutory income, but capital.[90] This is not strictly correct, as statutory income is income specifically caught by other provisions, such as sections 6-10 and 10-5. It includes capital gains under the CGT provisions in Part 3-1 under *ITAA 1997* section 102-5.

While the ID was restricted to 'life insurance', the ATO has extended the approach to TPD and trauma insurance in other statements.[91] For the owners and principals, this approach can have adverse consequences as discussed below.

2 Life and TPD—Taxing the Proceeds

Proceeds received from life insurance policies, regardless of whether they are used in succession planning, are generally not assessable income. The description of assessable income is contained in sections 6-5 ('ordinary income') and 6-10 (additional income that is not 'ordinary income' but rather 'statutory income').[92] *ITAA 1997* section 15-30 specifically states, in part, as to insurance:

> Your assessable income includes an amount you receive by way of insurance or indemnity for the loss of an amount (the lost amount) if:

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[88] Deutsch et al., *Australian Tax Handbook* (Thomson ATP, 2005) 71.
[89] ATO ID 2003/1189.
[90] A taxpayer's assessable income comprises of ordinary income (or 'normal income') and statutory income: *ITAA 1997* s 6-1(1). Ordinary income is income according to ordinary concepts, s 6-5(1), and includes, according to the courts, income from personal services, property and carrying on of a business. (See also ATO, *Assessability of Periodical Compensation Payments*, ID 2001/403, 22 June 2001). Also, see Lance Cunningham and Lucas Keegan, 'CGT Aspects of Business Succession Planning', *CGT Planning News* (Online, CCH Australia, 22 April 2005).
[91] See, for example, ATO TD 95/41; ATO, *Income Tax: Capital Gains: Is a Sum Obtained by a Taxpayer Under a Trauma Insurance Policy an Exempt Capital Gain Under Subsection 160ZB(1) of the Income Tax Assessment Act 1936?* TD 95/43, 9 August 1995; and ATO, *Income Tax—Assessability of Lump Sum Payment Received in Respect of Terminal Illness*, ID 2004/942, 11 November 2004.
[92] In particular, *ITAA 1936* s 6-10(2) states that 'Amounts that are not ordinary income, but are included in your assessable income by provisions about assessable income, are called statutory income'.

(a) the lost amount would have been included in your assessable income; and

(b) the amount you receive is not assessable as ordinary income under [*ITAA 1997*] section 6-5.

ITAA 1997 section 15-30(a) is circular and ambiguous to the extent that the Commissioner has deemed it necessary to attempt to give meaning to the section in ATO Interpretative Decision ID 2003/1189. The ID specifically responds to the question of whether life insurance proceeds received under succession planning agreements are capital or income. The Commissioner stated in the ID that:

> The courts have also examined the nature of the proceeds from life insurance policies. In *Marac Life Assurance Ltd v Commissioner of Taxation* [1986] 1 NZLR 694 the Court of Appeal concluded:[93]
>
>> Nothing in the *Income Tax Act 1976* [NZ] specifically exempts proceeds of life insurance policies from income tax, but it is common ground that traditionally such proceeds have been treated as capital; and this view is supported by *Re The Income Tax Acts* (1900) 26 VLR 297.

The lump sum proceeds of a life policy are considered capital and not assessable as ordinary income.[94] This is the case even though they may be received in more than one instalment. Similarly, an amount received on the surrender of such a policy (such as when a whole of life policy is 'cashed in') is also treated as capital.[95] However, the fact that the policy provides for the payment of a pension or annuity and not a fixed sum, or allows the beneficiary the choice between a fixed sum and a pension, means that the pension payments may be wholly or partly assessable income.[96] The legislation, on this set of facts, is unclear and would benefit by way of clarification on this point.

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[93] ATO ID 2003/1189.

[94] The concept of 'ordinary income' is considered in Chapter Five.

[95] As set out in Chapter Two, whole of life insurance has an investment component that has a cash value payable by the insurance company.

[96] As to the pension, see *ITAA 1936*, pt III div 2 sub-div AA. Where the life policyholder has control over the investment of the funds paid over as premiums, the income credited to the investor's account is assessable income to the investor derived at the time. The Commissioner also takes this

3 Trauma—Taxing the Proceeds

Like life and TPD policies, the proceeds of trauma insurance are generally not assessable income. However, this is based on a different approach to trauma policies by the ATO. ATO Interpretative Decision ID 2004/942 specifically seeks to deal with the question of whether a lump sum payment received by a taxpayer under a trauma policy is assessable under *ITAA 1997* section 6-5. The Commissioner took the view that it was not, because:[97]

> The lump sum payment is not earned by the taxpayer, as it does not directly relate to services performed. Rather the lump sum relates to personal circumstances that have arisen during the taxpayer's life. The payment is also a one-off payment and thus does not have an element of recurrence or regularity. Although the payment can be said to be expected, and perhaps relied upon, this expectation arises from the investment in insurance, rather than from a relationship with personal services performed. Thus, the lump sum payment is not considered ordinary income and is therefore not assessable under section 6-5(2) of the *ITAA 1997*.

In light of this, the proceeds of trauma insurance along with death and TPD generally fall outside the meaning of 'ordinary income'.[98] Insurance owned in a superannuation fund is an exception. This is now considered.

4 Superannuation—Taxing the Proceeds

The superannuation fund's trustee is generally treated the same as an individual taxpayer for income tax purposes. This is notwithstanding a superannuation fund's reduced tax rates and other concessions.[99] However, the insurance has different income tax consequences when owned in a superannuation fund. Generally, the proceeds of life insurance policies (not including TPD and trauma insurance) received by the fund are not assessable as ordinary income pursuant to the rules

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position in ATO, *Income Tax: Insurance: Does a Life Insurance Policy Exist for Taxation Purposes Where the Policy Holder is Entitled to Direct the Investment Activities of the Assets Underlying the Investment?* TD 92/166, 1 October 1992. However, this does not apply where the investor merely has the right to direct that the investment be placed in a particular class of investment operated by the insured or investors generally.

[97] ATO ID 2004/942.

[98] 'Ordinary income' is as per above n 91.

[99] *ITAA 1936* s 272.

discussed above.[100] This is provided by *ITAA 1997* section 118-300, which prohibits the effect of the CGT provisions and income tax applying to life insurance on the life of an individual 'to the extent it provides for a payment to be made if an event happens that results in the death of an individual'.[101] *ITAA 1997* section 118-300 expressly extends the CGT exemption to superannuation funds.

As discussed above, under the taxation system, payouts for TPD may be subject to CGT. There is also an exemption for TPD and trauma insurance. If the TPD and trauma come within the operation of the *ITAA 1997* section 118-37 exemption, then the capital gain is disregarded.[102]

However, '[s]ection 118-37 (unlike section 118-300) does not, on its wording, extend to trustees of any kind, including trustees of superannuation funds'.[103] Therefore, the CGT-free status does 'not appear to apply to a trustee of a superannuation fund'.[104] Consequently, the *ITAA 1997* extends a tax exemption for life insurance (under *ITAA 1997* section 118-300), but not for TPD and trauma held in a superannuation fund.

The ATO holds the view that this was not the legislative intention, stating that 'Treasury has advised that it is not inappropriate to exempt trauma (etc) insurance

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[100] See the discussion above relating to *ITAA 1997* ss 6-5, 6-10 and 15-30.

[101] ATO, *Income Tax: Capital Gains Tax: Is a 'Policy Of Insurance on the Life of an Individual' in Section 118-300 of the Income Tax Assessment Act 1997 Limited to a Life Insurance Policy within the Common Law Meaning of that Expression?* TD 2006/D36, reissued as TD 2007/4 [24]. The Commissioner in ATO TD 2007/4 took the position that 'a policy of insurance on the life of an individual' in *ITAA 1997* ss 118-300(1) has the same meaning as a 'life insurance policy'. After this TD, Items 3 to 6 of ss 118-300(1) were amended under the *New Business Tax System (Miscellaneous) Act (No. 2) 2000,* to replace the defined term 'life insurance policy' with the expression 'policy of insurance on the life of an individual'. The explanatory memorandum stated that [5]:

> the amendments ensure that ... sections 118-300 and 152-20 are restricted to those policies that qualify as life insurance policies under the current law, that is, policies of insurance that are taken out on the life of an individual.

Further, the Commissioner argued that the expression 'policy of insurance on the life of an individual' is not restricted to the common law meaning of that term. The Commissioner, however, does concede that s 118-300 can include an outgoing principal's death because of a TPD or trauma illness. A TPD policy payout may still be exempt under s 118-300 if it is paid for the outgoing principal's death rather than for a TPD event that does not lead to death. This also applies where a trauma event leads to death.

[102] *ITAA 1997* s 118-37 is considered later in this chapter.

[103] ATO National Tax Liasion Group, *Losses and CGT Sub-committee Minutes* (16 November 2005) Item 9.1.

[104] ATO *Income Tax—Capital Gains Tax: Exemptions—Proceeds of Continuous Disability Policies*, ID 2004/313, 31 March 2004 stated that payments under a continuous disability policy (as defined in the *Life Insurance Act 1953*) are only exempt under s 118-300 if the payment is made because of the death of the insured. Therefore, TPD and trauma are not afforded the CGT exemption under s 118-300. See Sue Merriman, 'Tidy Up Tax on Cover in Super', *Asset* (Financial Review, October 2011) 16–17.

proceeds in the hands of superannuation fund trustees'.[105] Some commentators have questioned the Commissioner's approach and asked:[106]

> Given that there is no legal basis for the concessional treatment for trustees, why stop at trustees, why not extend the approach to employers, if they use the insurance proceeds to make payments to employees? This is clearly wrong at law but no less wrong than the concession proposed.

The Commissioner has stated that, even though the legislation does not provide for it, the CGT relief from *ITAA 1997* section 118-37 is extended to superannuation funds. The ATO stated in 2004 that '[i]t was noted that while a legislative clarification was needed, in the interim reliance on the Tax Determination would be satisfactory'.[107] While amendments have been proposed to address the issue, to date there has been no such 'legislative clarification'.[108] Apart from 'limited' powers generally restricted to regulations and discretions, the ATO has no authority to make law.[109] In *BHP Billiton Direct Reduced Iron Pty Ltd & Another v DFCT*, French CJ cautioned that:[110]

> The word 'ruling' has an obvious capacity to mislead. It is capable of conveying the impression that rulings published by the Commissioner have legal force. Insofar as it relates to the interpretation of the law, a ruling has no greater status than an administrative opinion. In so far as it relates to the way in which a discretion

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[105]ATO National Tax Liasion Group, 'A Compendium of Responses to Issues Raised by External Parties to the Draft Discussion Paper on Insurance Policies and CGT, Summary of Issues Raised and Responses', *Losses and CGT Sub-committee Minutes* (16 November 2005) Annexure B.

[106] ATO National Tax Liasion Group, above n 104.

[107] Ibid.

[108] In the 2011 Federal Budget, the Government proposed amendments to the CGT provisions to provide greater certainty for taxpayers by fixing this deficiency. Among other amendments, the superannuation-related amendments deal with the CGT exemption for insurance payments. The proposals seek to remove uncertainty on how the income tax provisions apply by providing a CGT exemption for payments received from life insurance policies (including continuous disability policies such as TPD and trauma) by a trustee of a complying superannuation entity. The change, if passed, will apply to CGT events happening from and including the 2005/2006 financial year. See the Treasury proposals paper 'Minor Amendments to the Capital Gains Tax Law', issued in May 2011 (http://www.treasury.gov.au/documents/2041/PDF/Proposals_Paper_CGT_Minor_Amendment_Package.pdf). However, according to Merriman, above n 105, 16:

> The recent announcements propose legislative changes, such that the CGT exemption in [*ITAA 1997*] section 118-300 will be extended to cover [trauma and TPD in superannuation, such that they] … will no longer need to rely on ATO 'goodwill'.

[109] The Commissioner's limited power comes under *Income Tax Regulations 1936* and *Income Tax Assessment Regulations 1997*. These are considered in Woellner et al., above n 19, [1-490, 1-520].

[110] [2011] HCA 17, (2011) 277 ALR 224, ATC 5071, 5095. French CJ is also, as to this case, cited in Woellner et al., above n 19, [30-472]; see also Diana Scolaro, 'Tax Rulings: Opinion or Law? The Need for an Independent Rule-Maker' (2006) 16 *Revenue Law Journal* 109.

> conferred by law would be exercised, it has no greater status than an administrative policy. There is a risk of an unwarranted elevation of rulings, by virtue of their terminology to a kind of 'de facto law'.

If the matter were judicially considered, the court would be bound to follow the legislation. This is rather than the taxation regulator's thoughts on how the legislation should have been drafted.[111]

The unlegislated position taken by the ATO, the expressly stated need by the ATO for 'legislative clarification' with no such clarification being provided, and the ATO statement that the ignoring of the current law is 'satisfactory', which implies the courts would adopt the ATO's position, fails the taxation benchmarks.[112]

D. Capital Gains Tax—On the Insurance Payout

The above sections of this chapter have considered, predominantly, the effect of income tax other than CGT on the insurance. Whether the insurance as a lump sum payment is on revenue or on capital account often depends on the factual circumstances of each succession plan.[113] As shown above, the nature of the insurance proceeds in the hands of the recipient need to be determined.[114] This final section of the chapter considers how CGT treats the proceeds of life, TPD and trauma insurance and the CGT exemption under *ITAA 1997* section 118-300.

For CGT to apply a CGT event must occur. Although not always the case, there is often a CGT asset.[115] A 'CGT asset' is defined widely by *ITAA 1997* section 108-

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[111] See, generally, Roman Tomasic and Brendan D Pentony, *Tax Compliance and the Rule of Law: From Legalism to Administrative Procedure?* (1991) Australasian Law Teachers' Association, 85.
[112] ATO National Tax Liasion Group, above n 104, Item 9.1.
[113] See *FCT v Northumberland Development Co Pty Ltd* (1995) 59 FCR 103, 95 ATC 4483, (1995) 31 ATR 161, (1995) 59 FCR 103, (1995) 138 ALR 89, which dealt with the compulsory acquisition of commercial property.
[114] *Liftronic Pty Ltd v FCT* 96 ATC 4425.
[115] It is incorrect to say that a CGT asset is required for the CGT provisions to apply; for example, see event D1. Only a CGT event is required as per *ITAA* 1997 s 102-25. In Australia, one of the effects of CGT is tax gains made on the 'disposal' of assets and tax paid on the receipt of capital amounts. As to CGT and the history of CGT, see generally, Woellner et al., above n 19, 492. CGT seeks to tax taxpayers who receive 'income' through capital gains over and above income derived as 'ordinary income' (*ITAA 1997* s 102-5) or as statutory income such as wages and salaries (*ITAA 1997* s 104-10). CGT often applies to gains that arise from the disposal, including the sale, of a capital asset. The resulting net capital gain (*ITAA 1997* s 102), through the CGT regime, is added (*ITAA 1997* s 102-5) to the taxpayer's assessable income. As to the relationship between CGT and ordinary income in relation to life insurance, the

5(1) as any kind of property or a legal or equitable right that is not property.[116] This definition is sufficiently wide to include insurance policies and the proceeds of insurance. *ITAA 1997* section 108-5(1), Note 1, provides that a 'right to enforce a contractual obligation' is a CGT asset.[117] As a result, rights under an insurance policy are within the definition of a CGT asset. Further, that an insurance policy is a CGT asset is also inferred by the wording of section 118-300.[118] This specifically exempts policies of 'life insurance' from CGT liability under certain circumstances.[119] This exemption would be otiose if those policies were not CGT assets.[120]

As to the requirement of a CGT event, *ITAA 1997* Division 104 exclusively defines CGT events. For each CGT event, Division 104 specifies the cause and the timing of the event. For example, these include a 'disposal' of a CGT asset,[121] bringing into existence a CGT asset, creating a trust and dealing in shares.[122] Section 104-10(2) defines the disposal of an asset as 'a change of ownership … from you to another entity, whether because of some act or event or by operation of law'.[123] This potentially includes a number of transactions in a succession plan, such as a transfer or disposal of an insurance policy or insurance proceeds under CGT event A1.[124] As a result, CGT event A1 can arise on the transfer of an insurance policy.[125]

2011/2012 Federal Budget <http://www.budget.gov.au/2011-12/content/bp2/html/bp2_revenue-07.htm> stated that:

> Ensuring that gains and losses arising from life insurance policies that are generally exempted from CGT are not then taxed under the ordinary income tax provisions by removing the exception to the 'CGT primary code' rule for such gains and losses. This will remove uncertainty in the application of income tax to compensation or damages payments made under life insurance policies. These changes will apply to CGT events happening in the 2005‑06 income year and later income years. See also *ITAA 1997* Division 104.

[116] *ITAA 1997* pt 3-1 defines and regulates capital gains.
[117] See fn 31 in Chapter Four above regarding Notes in *ITAA 1997*.
[118] Previously, *ITAA 1936* ss 160ZZH and 160ZZI.
[119] David Morrison, *Taxation Law in Principle* (Thomson ATP, 2003) 48.
[120] This covers the rights and interests in the policies rather than the proceeds. Nevertheless, because of the wide drafting of *ITAA 1997* s 108-5(1), the proceeds of the life insurance would be CGT assets.
[121] *ITAA 1997* s 104-10(2).
[122] Respectively: CGT events D1 to D3 (*ITAA 1997* ss 104-35–104-45); CGT event E1 (*ITAA 1997* s 104-55) and CGT events G1 to G3 (*ITAA 1997* ss 104-135–104-145).
[123] This is contained in *ITAA 1997* div 104.
[124] Potentially a CGT event occurs whenever there is:

- transfer or assignment of the insurance policy;
- surrender of the policy;
- payment of any proceeds on the insurance; or
- other similar dealing with the policy.

Even before insurance proceeds are distributed (according to the terms of the succession agreement), the policy's proceeds represent the transfer of a capital amount from the insurance company to the policy

Depending on the type of insurance, some insurance proceeds used in succession plans are potentially CGT exempt. *ITAA 1997* section 118-300 provides that a capital gain or loss from a life insurance policy be ignored, subject to certain requirements, for CGT purposes.[126] It states, in part:

> **Income Tax Assessment Act 1997—Section 118-300**
>
> **Insurance policies**
>
> (1) A capital gain or capital loss you make from a CGT event happening in relation to a CGT asset that is your interest in rights under a general insurance policy, a life insurance policy or an annuity instrument is disregarded in the situations set out in this table.

owner. A CGT event takes place when the policyholder gives up his or her rights under the policy in exchange for receiving the insurance proceeds. Assuming the premiums are less than the proceeds, the policyholder makes a taxable capital gain.

[125] CGT event A1 deals with a disposal of a CGT asset, as discussed above. In *Burke v Commissioner of Taxation* [2004] FCA 126, (2004) ATC 4198, (2003) 54 ATR 1007, the taxpayer creatively argued that shares in AMP were 'life insurance' for the purposes of the s 118-300 exemption in that the 'shares disposed of should be perceived to be his interest in rights under his AMP policy', per Member DJ Trowse, 2019. However, the court decided that the taxpayer acquired the shares because of his previous membership of AMP and not from his rights under any insurance policy.

[126] The section is in the form of a table and Items 3 to 6 refer specifically to 'policies on the life of an individual or an annuity instrument'. As stated in the section of the legislation, as well as 'life insurance', the exemption also applies to an annuity instrument and a general insurance policy. It does not apply to TPD or trauma, which is discussed later in the chapter.

Item	The CGT event happens to this type of policy	... and you are[127]
1	Any insurance policy or annuity instrument	the insurer or the entity that issued the instrument
2	A general insurance policy for property where, if a CGT event happened in relation to the property, any capital gain or capital loss would be disregarded	the insured
3	A policy of insurance on the life of an individual or an annuity instrument	the original beneficial owner of the policy or instrument
4	A policy of insurance on the life of an individual or an annuity instrument	an entity that acquired the interest in the policy or instrument for no consideration
5	A policy of insurance on the life of an individual or an annuity instrument	the trustee of a complying superannuation entity for the income year in which the CGT event happened[128]

[127] Emphasis and points of ellipsis in the emphasis in original. The relevant amendments (in chronological order) affecting Items 3 and 5 and their application dates are noted below. (The amendments to ss 118-300(1), which do not affect Items 3 and 5, are not included.)

- Section 118-300 was first inserted into the *ITAA 1997* by the *Tax Law Improvement Act (No. 1) 1998* (Act No. 46 of 2008), as applicable to assessments for the 1998/99 and later income years. As enacted, Items 3 and 5 s 118-300(1) *ITAA 1997* read:

  Item 3 - A life insurance policy ...
  - the original beneficial owner of the policy or instrument ...

  Item 5 - a life insurance policy ...
  - the trustee of:
  (a) a complying superannuation fund; or
  (b) a complying approved deposit fund; or
  (c) a pooled superannuation trust;
  for the income year in which the CGT event happened

- Amendment 1: An amendment to the *New Business Tax System (Integrity and Other Measures) Act 1999* (Act No. 169 of 1999) was made by removing the ss 118-300(1) Table Item 5 (as then existing), and substituting:

  Item 5 - a life insurance policy or an annuity instrument
  - the trustee of a complying superannuation entity for the income year in which the CGT event happened.

  The amendment applies to assessments for the income year including 21 September 1999 and later income years.
- Amendment 2: s 118-300(1) Items 3, 4 and 5 were amended by the *New Business Tax System (Miscellaneous) Act (No. 2) 2000* (Act No. 89 of 2000) by substituting ‘policy of insurance on the life of an individual’ for ‘life insurance policy’ in those Items. This took effect from 30 June 2000.

[128] The exemption is restricted to certain CGT events listed in the legislation. The events relevant to succession planning are:

A1—disposing of a CGT asset;
C2—cancelling, satisfying and surrendering a CGT asset;
E1—creating a trust over a CGT asset;
E2—transferring a CGT asset to a trust;

While section 118-300 Item 3 exempts 'life insurance', Item 1 exempts 'any insurance' and Item 2 exempts 'a general insurance policy for property'. However, both Items 1 and 2 restrict the CGT exemption to the person issuing the policies, being the insurance company.[129]

The section 118-300 CGT relief when there is a transfer of the life insurance policy is only provided if at least one of the two following requirements is satisfied:[130]

a) under Item 3, the life insurance is owned and the proceeds are paid to the policy's 'original beneficial owner' ('original beneficial owner requirement'); or

b) under Item 4, the proceeds are paid to an assignee of the policy who acquired the rights or interest in the policy for no consideration ('no consideration requirement').

1 The Purpose of the CGT Exemption for 'Life Insurance'

In seeking to understand the purpose of the section 118-300 CGT exemption, it is noted that CGT exemptions are often extended to related matters of physical injury and death where there is a transfer from the deceased estate to a beneficiary.[131]

While not a stated purpose, the two requirements under section 118-300 discourage trading in life insurance policies or using them as a form of currency or security to avoid

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E7—disposing of a CGT asset to the beneficiary to end the capital interest; and
E8—disposing of a CGT asset as to the capital interest by the beneficiary.

The other events that are not generally relevant to succession planning are CGT events B1, E3, E5, E6, I1, I2, K3 and K4.

[129] Section 118-300 Item 1 applies to disregard a capital gain or capital loss arising on 'any insurance policy or annuity instrument'. However, this is only where the taxpayer is the insurer or the entity that issued the instrument.

[130] CGT exemptions are extended to a large number of situations and assets including motor vehicles and personal use assets (*ITAA 1997* div 118 of pt 3-1), the main residence exemption (sub-div 118-B) and the small business exemptions.

[131] As to physical injury, see *ITAA 1997* s 118-37(1)(a) and (b). Compensation or damages received by a taxpayer for any wrong, injury or illness suffered personally by the taxpayer or a relative, or received for any wrong or injury suffered by the taxpayer in the taxpayer's occupation is disregarded for CGT purposes. This is discussed later in the chapter. As to death, this is under and subject to the requirements and qualifications contained in *ITAA 1997* s 128-10.

CGT.[132] Without such a rule in place, business owners could use beneficial interests in life insurance policies as part of the purchase price for the business, lowering CGT in the process. The Commissioner also acknowledged this in the opening paragraph of Taxation Determination TD 94/31, which dealt with the precursor to section 118-300. He stated:[133]

> The exemption from Part IIIA provided by section 160ZZI is intended to apply to all disposals of rights, or any interest in rights, under a life assurance policy **other than** where a person trades or deals (including holding until maturity) in those rights, or any interest in those rights, as a result of acquiring them for money or other consideration from a previous owner.[134]

As in Australia, capital gains are taxed in the US through discrete provisions of its income tax legislation.[135] Under the US *Internal Revenue Code,* the proceeds of life insurance policies are generally excluded from the gross income of the insured party. Life insurance proceeds are, therefore, generally exempt from taxation.[136] This is analogous, but broader, to the exemption from CGT on life insurance proceeds under *ITAA 1997* section 118-300.

This section of the chapter identifies three problems: (1) the application of the 'original beneficial owner' requirement; (2) the application of the 'no consideration' requirement; and (3) the section 118-300 CGT exemption only applying to the proceeds received on policies of 'life insurance', as distinct from TPD and trauma.[137] These three issues are now considered.

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[132] All Explanatory Memorandums on this and previous sections are silent on this point.
[133] ATO, *Income Tax: Capital Gains: What is Meant by the Term 'Original Beneficial Owner' as Used in Subsection 160ZZI(3) of the Income Tax Assessment Act 1936 (The Act)?* TD 94/31, 21 April 1994 continues to be the most recent statement from the ATO on this matter. It has not been withdrawn.
[134] Emphasis in original.
[135] *Internal Revenue Code* 26 USC, ss 1201–1298
[136] However, an issue for cross-purchase agreements in the US is the 'Transfer-for-Value' rule, which seeks to stop speculation on the death of the insured. It states that if the right to receive the proceeds of the life insurance is transferred to another party for valuable consideration (this is, where another party buys the right to the proceeds), the payout is subject to taxation.
[137] See the Explanatory Memorandum, *Tax Law Improvement Bill (No. 1) 1998, Tax Law Improvement Act (No. 1) 1998*.

2 Application of the 'Original Beneficial Owner' Requirement

While the term 'beneficial owner' is used a number of times, the term 'original beneficial owner' is only used once in the *ITAA 1997*, being in section 118-300.[138] Neither 'beneficial owner' nor 'original beneficial owner' is defined in the taxation legislation. 'Original beneficial owner' has no accepted legal meaning in trust law. Nevertheless, the legislative wording does not restrict two or more persons together from being the first owners of the life insurance policy. Each is an 'original beneficial owner'. Further, the legislation does not limit the type of entities that could own the insurance and claim the 'original beneficial ownership' status. Entities used in a succession plan, such as individuals, partnerships, trustees and companies, may seek the exemption.[139]

The term 'beneficial owner' is used in some State and Territory land tax and transfer legislation. However, it remains undefined in the legislation.[140] An understanding of the terms 'beneficial owner' and a 'change' (to help identify the concept of 'original') in beneficial owner can be gained from the common law relating to land tax cases.[141] The term 'beneficial owner' was considered by the Court of Appeal

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[138] For example, *ITAA 1997* s 165-205 (Also, *ITAA 1936* s 80B(3)) deals with the death of the beneficial owner; *ITAA 1936* s 80(5) deals with the nature of ownership of shares; s 165-180 gives the Commissioner power to treat a taxpayer as not having beneficially owned certain shares; the now former *ITAA 1936* s 80D dealt with the tracing of the beneficial ownership of shares through interposed companies and *ITAA 1936* sub-div 272-D, working in operation with *ITAA 1997* s 165-207, deals with family trusts.

[139] For example, the implication of *CSR Ltd v FCT* (2000) ATC 4215 is that a company was able to take the benefit of the CGT exemption. The Commissioner adopts a similar line of reasoning in ATO TD 94/31.

[140] See for example, *Stamp Duties Act 1920* (NSW) ss73(2AE)(a),(c) and 73(2AF)(b), where a conveyance is not charged with *ad valorem* duty because there is no change in beneficial interest. However, the *Duties Act 2000* (Vic) s 7 does define 'change in beneficial ownership' to include:

> (a) the creation of dutiable property;
> (b) the extinguishment of dutiable property;
> (c) a change in equitable interests in dutiable property;
> (d) dutiable property becoming the subject of a trust;
> (e) dutiable property ceasing to be the subject of a trust.

See also, *Amendments in Relation to Certain Leases and Beneficial Ownership Duties Amendment Act 2009* s 4 pt 2, No. 39 of 2009, 5–6.

[141] I Andrew Tokley, *Company Securities—Disclosure of Interests* (1995) 25; as to non-common law jurisdictions in which the concept is not used, see Charl P du Toit, *Beneficial Ownership of Royalties in Bilateral Tax Treaties* (1999) 99 and Stichting Internationaal Belasting Documentatie Bureau (IBFD), *European Taxation* (ET) (1981) 141, 143.

(England) in *Parway Estates Ltd v Commissioner of Inland Revenue*, where the court stated:[142]

> I rest my judgment in the main on this: when you look at the words 'beneficial owner' in section 42 of the *Finance Act 1930* [UK], those words must in my judgment be construed in ... their … ordinary or popular sense ... [W]hen one looks at the facts of this case, and asks oneself was [Parway] in its popular or ordinary sense the beneficial owner of the shares there can only be one answer to that question: it was not; it was bound by contract to transfer them to another the very next day.

The *Parway* decision uses the term 'beneficial interest' to mean the same as 'equitable interest'.[143] Similarly, Sheppard J in *Malaysia Shipyard and Engineering Sdn Bhd v The Iron Shortland*, in considering the meaning of 'owner' in a non-revenue context, applied 'beneficial ownership' and 'equitable ownership' interchangeably:[144]

> The question I have to decide is whether 'owner' in [*Admiralty Act 1988* (Cth)] section 19 means or includes a beneficial owner as distinct from the registered owner. ... Undoubtedly, the word is ambiguous. It could mean registered owner, equally it could refer to the beneficial owner.

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[142] (1958) 45 TC 135, 142. This notion of control of the asset and the ability to deal with and control the asset as the 'beneficial owner' sees fit, over the authority of a person with legal or some other title, is also reflected in *Wood Preservation Ltd v Prior (Inspector of Taxes)* [1969] 1 All ER 364.

[143] See also the High Court decision in *Commissioner or Stamp Duty (NSW) v Bradhurst* (1950) 81 CLR 199, Williams J, 221; In *Lygon Nominees Pty Ltd v Commissioner of State Revenue* [2007] VSCA 140, [90], Redlich JA stated:

> The phrase 'beneficial owners' in [*Land Tax Act 1958*, Vic] s 52 has the same meaning as 'the owner of an equitable estate or interest' in s 51. The owner must be entitled, in equity, to the freehold estate in possession in relation to the land the subject of the trust.

Similar to in *Parway*, in *Leigh Spinners Ltd v IR Commissioners* (1956) 46 TC 425, the registered shareholder was not the beneficial owner, since he or she was at all times obliged to transfer the shares to others. Also in *IR Commissioners v Ufitec Group Ltd* (1977) 3 All ER 924, the taxpayer was no longer the beneficial owner of shares because he or she was bound to deal with the shares under the direction of other persons, pursuant to an agreement.

[144] (1995) 59 FCR 535; (1995) 131 ALR 738, 747–478. This case was confirmed by the Full Federal Court decision in *Kent v The Vessel Maria Luisa* (2003) 130 FCR 12.

Similarly, Allsop J in delivering a conference paper, also in a non-revenue context, stated:[145]

> The essence of the phrase 'beneficial ownership' … is equitable ownership, involving the right to sell and pass ownership rights. It is a question of title, not economic utilisation. It is a question of legal analysis of proprietary rights, not a practical analysis of substantive economic domain.

Like 'beneficial interest', the term 'equitable interest' remains undefined in the *ITAA 1997*. In considering what these two terms mean in their ordinary meaning, 'equitable interest' is defined in the *Macquarie Dictionary* as:[146]

> 'equitable interest': The interest in a property which derives from the legal or nominal interest of the trustee. Compare beneficial interest.

Similarly, 'beneficial interest' in the *Macquarie Dictionary* is defined as:[147]

> 'beneficial interest': An interest in a property, as in the property of a trust, held by a beneficiary to the trust. Compare equitable interest.

Similarly, *Black's Law Dictionary* defines 'beneficial interest' as 'profit, benefit or advantage resulting from a contract, or the ownership of an estate as distinct from the legal ownership or control'.[148] All three definitions suggest that the term 'beneficial interest' equates to an equitable interest or is related to the notion of an equitable interest.

In contrast to the above cases and the dictionary definitions, other courts have decided that the term 'beneficial owner' is different from 'equitable owner'.[149] To

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[145] J Allsop, 'Possible Issues in Admiralty Reform: (a) beneficial ownership and jurisdictional facts; and (b) the nature of arrest and disclosure' (Maritime Law Association of Australia and New Zealand (MLAANZ) Conference, October 2003) 13.

[146] *The Macquarie Dictionary Online* (Macquarie Dictionary Publishers Pty Ltd, 31 January 2012) <http://www.macquariedictionary.com.au>.

[147] Ibid.

[148] Bryan A Garner, *Black's Law Dictionary* (Deluxe 9th ed, 2009) 956.

[149] See *Adele Grace Pty Ltd v Commissioner of Land Tax* [1977] 2 NSWLR 382, 386, where the terms 'beneficial owner' and 'equitable owner' are considered. See also Lord Diplock's comments, where the term is taken to mean ownership for one's own benefit, rather than for the benefit of others, as suggested

have a 'benefit' in an asset is not necessarily based 'on the jurisdictional divisions between legal and equitable interests'.[150] Further, a 'beneficial owner' is not restricted to a beneficiary and trustee relationship. There does not necessarily need to be a fiduciary obligation. For example, a life tenant and remainder person both have a beneficial interest in the same parcel of land. However, there is no requirement for a fiduciary relationship to exist between the two.[151] Support for this view is provided by Nourse LJ in *J Sainsbury plc v O'Connor*, who stated that 'beneficial ownership' was:[152]

> ownership for your own benefit as opposed to ownership as trustee for another. It exists either where there is no legal division of legal and beneficial ownership or where legal ownership is vested in one person and the beneficial ownership, or which is the same thing, the equitable interest in the property in another. However, both are beneficial owners over the same asset, being the land.

Commentators have expressed concern about the term 'beneficial ownership'. Speed, for example, stated that:[153]

> There is much confusion concerning legal and equitable ownership, confusion which quickly becomes chaos when beneficial ownership joins the melee. Much of this is caused by the use of imprecise language.

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in *Ayerst (HMIT) v C&K (Construction) Ltd* (1976) AC 167, 177, where his Lordship stated that the concept derives its origins from the Court of Chancery and further stated that:

> The archetype is the trust. The 'legal ownership' of the trust property is in the trustee, but he holds it not for his own benefit but for the benefit of the cestui que trust or beneficiaries. Upon the creation of a trust in the strict sense as it was developed by equity the full ownership in the trust property was split into two constituent elements, which became vested in different persons: the 'legal ownership' in the trustee, and what came to be called the 'beneficial ownership' in the cestui que trust.

[150] See Margaret Stone and Vanessa Lesnie 'Some Thoughts on Beneficial Interests and Beneficial Ownership in Revenue Law' [1996] *UNSW Law Journal* 181, 182–183, where it is argued that confusion arises because of the failure to use the term 'equitable'. It is further stated that:

> In linking the concept of beneficial ownership to legal and equitable interests, the legislature [being the States in this instance] has attempted to 'piggy-back' on the established rules for the creation and transfer of property interests. … And inevitable creates difficulties by using concepts which developed for different purposes.

See also *Wood Preservation Ltd v Prior* [1969] 1 WLR 1077, 45 TC 112, but compare with the case of *J Sainsbury plc v O'Connor* (1991) STC 318, 330.

[151] Even the obligation of the life tenant to insure and maintain the property is often enshrined in the legislation, rather than as an obligation under equity or common law. See, for example, *Settled Land Act 1958* (Vic) s 88(1), which states in part:

> The tenant for life ... shall ... maintain and repair, at his own expense, every improvement ... and where a building or work [is] in its nature insurable ... at his own expense insure and keep insured the improvement

[152] (1991) STC 318, 332.

[153] Robin Speed, 'Beneficial Ownership' (1997) 26 *Australian Tax Review* 34, 41.

Potentially, a party to the succession plan could gain a 'beneficial interest' in the insurance by holding either an equitable or a legal interest. Further, irrespective of who holds the insurance (either equitably or legally) or who is to receive the proceeds, each and every party to the succession planning agreement could potentially hold a 'beneficial interest' over the insurance within the context of *ITAA 1997* section 118-300.

To gain the section 118-300 CGT exemption, the taxpayer must not only hold a 'beneficial interest', but also be the 'original' person to hold the beneficial interest. There is little authority on the term 'original' and, therefore, the term 'change' is considered to help interpret the concept of 'original'. In *BL & M Grollo Homes Pty Ltd v Comptroller of Stamps (Vic)*, the court held that a 'change' in beneficial ownership happened when an asset was transferred into a trust.[154] This was the case even though the beneficial owner remained the same.[155] Similarly, the High Court in *Halloran v Minister Administering National Parks and Wildlife Act 1974* held that the acquisition of an interest in land by the trustee of a unit trust created a 'change' in the beneficial ownership of the land interest.[156] This was the case even though the transferor held all the units in the unit trust after the transfer.[157] This was because, per Nettle J:[158]

> It may well be that the income of the fund as finally constituted and distributed will include all of the rents and profits generated by a particular parcel of land within the fund. But it is distinctly possible that it will not. Each of the [unit trust] deeds gives power to the trustee to provide out of receipts for future and contingent liabilities; to apply receipts in the purchase of any property or business; to invest receipts in authorised investments and to deal with and transpose such investments; and the

[154] 82 ATC 4524; [1983] 1 VR 445. However, as stated in *Crambrook Nominees Pty Ltd & Blake Corp P/L v Commissioner of Taxes* [2000] NTSC 86 [56]:

> In the matter of *BL & M Grollo Homes Pty Ltd v Comptroller of Stamps (Vic)* [1983] 1 VR 445 the Court held that the statement in the transfer that the consideration was 'the transferee being entitled in equity' did not fully and truly set forth the consideration (Tadgell J at 448):
>
> > The true consideration for the transfer in this case being unexplained by the instrument designed to effect it, the respondent was obliged and entitled to have regard to the surrounding circumstances to the extent necessary to explain the operation and effect of the instrument and to ascertain the actual consideration, if any.

[155] On appeal, the NSW Court of Appeal upheld the decision of Studdert J by majority: see *Chief Commissioner of Stamp Duties (NSW) v ISPT Pty Ltd* (1998) 99 ATC 4066.

[156] [2006] HCA 3.

[157] See also *CPT Custodian Pty Ltd v Commissioner of State Revenue* (2005) ATC 4925, [2005] HCA 53.

[158] *Halloran v Minister Administering National Parks and Wildlife Act 1974* [2006] HCA 3.

only right of the unit holder is to a proportionate share of the income of the fund for the year.

This is in contrast to the Victorian Court of Appeal case of *Comptroller of Stamps v Yellowco Five Pty Ltd*[159] and the Supreme Court of NSW case of *ISPT Pty Ltd v Chief Commr of Stamp Duties (NSW)* ('ISPT'). Both decided, on similar facts, that no change in beneficial ownership occurred when an asset was transferred into a unit trust where the transferor was the sole unit holder.[160] However, in the ISPT case, the court stated that there might have been a change in beneficial ownership on the transfer if the trustee had received a right of indemnity over the trust property. This was on the basis that it would have given the trustee a 'beneficial interest' in the trust property.

The cases, therefore, provide little assistance in establishing a definition of 'beneficial owner' for the purposes of section 118-300. Further, based on the reasoning of the Victorian Court of Appeal in *Lygon Nominees Pty Ltd v Commissioner of State Revenue (Vic)* ('*Lygon*'), it may be possible for no taxpayer to have a 'beneficial interest' in the asset. In that situation, there would be no 'original' beneficial owner.[161] The facts were that the trustee was the trustee of 11 discretionary trusts. The State Commissioner assessed the trustee for land tax on all the land held in the trusts. The court decided that the rights of the default beneficiaries of the family trusts, while vested in interest, were not vested in possession. There were no 'beneficial owners' within the meaning of *Land Tax Act 1958* (Vic) section 52.

Under this case's authority, it is possible for there to be no 'original' beneficial owner under section 118-300. Mandie J in *Lygon* stated that no change in beneficial ownership was possible because there was no beneficial owner of the assets at any relevant time, either before or after the transaction. Since the legislation used the

[159] 93 ATC 4025.
[160] 98 ATC 4084.
[161] [2007] VSCA 140. Alternatively, the original beneficial owner would be established later.

expression 'beneficial ownership', changes to equitable interests were not caught by the legislation.[162]

The above discussion demonstrates that the common law definition of 'original beneficial owner' is both complex and ambiguous. *A fortiori*, because the concept of 'ownership' is not itself consistently interpreted by the courts, Speed cautions that:[163]

> [t]he words 'beneficial ownership' ... have no historical or contemporary universal meaning. It is therefore necessary on each occasion where the words appear to carefully determine their meaning having regard to, but not enslaved by, past use and analysis.

Taxation Determination TD 94/31 seeks to interpret the term 'beneficial ownership'.[164] Without finding it necessary to refer to case law, the Commissioner sets out a number of cumulative tests: these begin with the person needing to possess 'all the normal incidents of beneficial ownership'. This is a circular argument and has little definitional value. In seeking to shed light on the concept, the Commissioner provides 'examples', although, in the context, they are more than examples. They are presented as cumulative mandatory requirements. The taxpayer is required to demonstrate, to the ATO's satisfaction, that the 'original beneficial owner' exemption is satisfied. Support that the 'examples' are mandatory is based on the Commissioner using the word 'and' in bold font between the examples. As to who is an 'original beneficial owner', this part of the ID stated:[165]

> [it] is the first person who ... for example, is entitled to the benefits of the policy proceeds **and** has the power of management and control over the policy as well as the power to transfer, grant as security, surrender or otherwise dispose of the policy.

There is no requirement that the original beneficial owner be the person who potentially suffers the death or disability. For example, the owners, rather than the outgoing principal, can hold the insurance. In this case, if the outgoing principal dies or is

[162] *Lygon Nominees Pty Ltd v Commissioner of State Revenue (Vic)* s 8 requires that the identity of the person who 'obtains' the beneficial ownership be identifiable.
[163] Speed, above n 154, 50.
[164] The TD has not been updated to the *ITAA 1997* section and still refers to *ITAA 1936* s 160ZZI(3).
[165] Emphasis in original. ATO TD 94/31 stated that this might also include the trustee in cases that there is trust ownership of an insurance policy. Arguably, this conflicts with the common legal separation of legal and beneficial ownership inherent in a trust.

disabled, then the insurance company pays the proceeds to the policyholders, being the owners. Irrespective of who owns the insurance policy, the insurance and the proceeds are dealt with under the terms of the succession planning agreement. The original beneficial owners fetter their power and incidence of ownership by agreeing to treat the insurance and proceeds pursuant to the terms of the succession plan. For example, the original beneficial owners may be required to hand the insurance proceeds to the outgoing owner and therefore potentially fail the test of being, in the words of the Commissioner, 'entitled to the benefits of the policy proceeds'.[166] Similarly, the TD requires 'management and control'.[167] However, the insurance is restricted and curtailed by the terms of the succession plan to such a level that the original beneficial owner may have neither 'management' nor 'control'. Further, pursuant to the succession plan, generally, the insurance policy cannot be, in the words of the TD, 'transferred', used as 'security' or 'surrendered'.[168]

In summary, the test in the original beneficiary ownership requirement fails the taxation benchmark of simplicity. The reason is that the term 'original beneficial owner' is ambiguous, especially in a succession planning context, making it inappropriate. The Commissioner's TD fails to provide a supportable explanation of the term and, in any event, a potential conclusion of the Commissioner's interpretation results in no person, who is party to a succession plan, being able to take advantage of the exemption. Legislative reform is desirable to remove uncertainty.

3 Application of the 'No Consideration' Requirement with the 'Original Beneficial Owner' Requirement

The two requirements to obtain the *ITAA 1997* section 118-300 CGT exemption for the transfer of life insurance are not cumulative. A disposal by a person who is not the original beneficial owner or who fails the no consideration requirement is not relevant if the person acquiring the insurance policy ('acquirer') provides no consideration for the life insurance.

What then is the position when the acquirer sells, for consideration, the policy back to the original beneficial owner? Does the original beneficial owner regain the CGT

[166] ATO TD 94/31 [3].
[167] Ibid.
[168] Ibid.

exemption? Does it make a difference if the acquirer itself had failed to satisfy either exemption because the acquirer was not the original beneficial owner and paid consideration to purchase the insurance? For example, a party to the succession plan, as the original beneficial owner of the life insurance ('original owner'), sells for consideration the insurance policy to another party to the succession plan, being the acquirer. The acquirer fails the section 118-300 exemption. This is because the acquirer is not the original beneficial owner and has not obtained the insurance for no consideration.

The status of being the original beneficial owner for the CGT exemption may be lost or contaminated by the transfer of the insurance policies to the acquirer and the transfer back to the original beneficial owner.[169] The legislation, Explanatory Memorandum and cases do not address this situation.

The section 118-300(1) exemption applies if 'you are … the original beneficial owner of the policy'. From one perspective, it is always the case because no other person could ever be the first owner of the policy. Irrespective of what happens to the insurance policy, that person will always be the first owner—or, in the words of the section, the 'original' beneficial owner. From that perspective, the status of being the first, or original, can never the taken away. It always remains true. It cannot be changed by subsequent actions.

Another interpretation, looking at the legislative intent, is that the exemption only applies if the original owner keeps hold of the insurance policy. Once transferred, the status is lost and can only be regained if the original owner re-gains the interest in the life insurance policy for no consideration. Without judicial interpretation or a legislative amendment, that answer remains unclear.

Another issue is that in which the original owner, after taking back the policy from the acquirer, then transfers the insurance policy back to the acquirer, but this time for no consideration. This is colloquially described by the High Court as a 'round robin'

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[169] Without providing justification, the CCH Tax Editors, *Australian Federal Tax Reporter* (CCH Australia Ltd, Daily Online Update) [155-010] holds the view that the status is retained, stating:

> The CGT exemption also applies if the taxpayer is the original beneficial owner under the policy who disposes of, and later reacquires, the rights under the policy for consideration (such gains or losses would not trigger the exemption under Item 4).

transaction.[170] Putting aside the general anti-avoidance provision of *ITAA 1936* Part IVA, the acquirer, this time, gains the advantage of the exemption because the acquirer satisfies the no consideration requirement.

To extend the example further, any person who transfers the insurance for no consideration provides the new owner with satisfaction of the no consideration requirement. This could be extended to a person who, rather than making a one-off purchase of an insurance policy as part of a succession plan, operates a business of acquiring life insurance policies.[171] Upon the acquisition, the acquirer could merely transfer the interest in the insurance policy to another entity, such as a spouse, trustee or a wholly owned subsidiary, and gain the CGT exemption due to having satisfied the no consideration requirement.[172]

The Commissioner may argue that some of the above gratuitous transfers of life insurance policies are so 'blatant, artificial or contrived' as to have the dominant purpose of reducing taxation obligations.[173] If so, they would fall foul of the general taxation anti-avoidance provisions found in Part IVA.[174] This is because the parties obtained a 'tax benefit'.[175] This benefit would not have been available if the 'scheme' had not been entered into.[176] The 'sole or dominant purpose' of entering into the agreement may have been to obtain the section 118-300 tax benefit.[177]

4 What Constitutes 'No Consideration?

A second requirement that allows for the satisfaction of the CGT concession is for the taxpayer to receive the life insurance policy for no consideration. The question that

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[170] For use of the expression, see *ASIC v Lanepoint Enterprises Pty Ltd (Receivers and Managers Appointed)* (2011) 29 ACLC [11-038].
[171] This is putting aside the issue of the insurance policies becoming trading stock and treated as ordinary income.
[172] Pursuant to *Grollo Nominees* 97 ATC 4585, *ITAA 1936* Part IVA could apply to such trust structures.
[173] This expression was cited with approval from the Explanatory Memorandum, *FCT v Consolidated Press Holdings Limited (No. 1)* (1999) 42 ATR 575, 166 ALR 1, 91 FCR 524, 99 ATC 4945 [149].
[174] As to the general impost of Part IVA, see above n 173.
[175] *ITAA 1936 s* 177C(1).
[176] *ITAA 1936 s* 177A(1) defines the term 'scheme' widely as:

> (a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied and whether or not enforceable, or intended to be enforceable, by legal proceedings; and
> (b) any scheme, plan, proposal, action, course of action or course of conduct.

[177] *ITAA 1936 s* 177C. For an explanation on the operation of Part IVA, see Robert O'Connor QC, *Commentary on Paper by Chris Bevan on Part IVA Amendments* (Taxation Institute of Australia, 21 June 2000).

arises, in the context of succession planning is: What constitutes ‘no consideration’? This is an important question because the contractual obligations in the succession plan may have such value as to mean that the no consideration requirement can never be satisfied.

As to the no consideration requirement, must the consideration be tangible, such as money or property, or can it be intangible, such as an exchange of promises or rights, the latter being what is provided under a succession plan?[178] The Commissioner’s Taxation Determination TD 94/32 provides a view on this question.[179] The TD stated that the no consideration requirement is satisfied if there is no ‘actual amount of money or other consideration’ exchanged in the transfer of the life insurance.[180] Putting aside the Commissioner’s use of the words ‘other consideration’, which is a circular argument, one interpretation of this statement is that there must be some form of tangible consideration before the no consideration exemption is lost.

If the Commissioner in the TD has correctly interpreted the legislation, then the parties to the succession planning agreement are not deemed to have given consideration by merely exchanging contractual rights. In the words of the TD, no ‘actual amount of money’ has changed hands.[181] The Commissioner also interprets ‘no consideration’, which is the term used in the legislation, as no ‘market value consideration’.[182] He suggests that something less than full market value constitutes no consideration for the purposes of the no consideration requirement. The word ‘no’, it is submitted, does not mean something less than market value. Rather, according to the *Macquarie Dictionary*, in this context, it means ‘not in any degree; not at all’.[183] It means a lack of any amount, rather than a lesser amount. The legislature seeks to shed light on this issue by providing an example in section 118-300(1). The example states:[184]

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[178] Doug Sumner, *Taxation of Risk Products* (Norwich Union, Internal Publication, 1999) 2.
[179] ATO, *Capital Gains: Where No Amount of Money or Consideration is Given for the Acquisition of any of the Rights, or an Interest in any of the Rights, Under a Policy of Life Assurance, and the Person Acquiring Such Rights is Not the Original Beneficial Owner, Will Section 160ZH(9) of the ITAA 1936 Deem Market Value Consideration in Section 160ZZI(3)?* TD 94/32, 21 April 1994.
[180] Ibid., [2].
[181] Ibid.
[182] Ibid., [3].
[183] *The Macquarie Dictionary Online*, above n 147.
[184] See fn 31 in Chapter Four above regarding Notes in *ITAA 1997.* The same holds true for the Examples.

> Example 2: Peter is the original beneficial owner of the rights under a policy of insurance on the life of an individual. He transfers the rights to his spouse for nothing. There are no CGT consequences for him, and none for his spouse if he dies.

Example 2 uses the expression 'nothing' for the consideration. Contrary to the Commissioner's position in TD 94/32, it would seem that any consideration (being something other than 'no consideration') operates to stop this requirement from being satisfied.

In any event, for there to be consideration, it is not generally required that money changes hands under the law of contract. The courts have stated that consideration:[185]

> may consist either in some right, interest, profit or benefit accruing to the one party or some forbearance, detriment, loss or responsibility given, suffered, or undertaken by the other.

Cheshire and Fifoot stated that a person can be bound by an agreement, that is, give consideration, and be 'liable just because he or she had made a serious promise or had made use of a well-known ritual that signals that a promise is to be treated as legally enforceable'.[186] A succession plan contains such promises.

For example, *ITAA 1936* section 21A accepts as consideration a 'non-cash business benefit' for the purposes of calculating income. From a GST perspective, *A New Tax System (Goods and Services Tax) Act 1999* (Cth) section 9-75 deems acceptable consideration as something other than money. Where the consideration is not money, the consideration is still 'the GST inclusive market value of that consideration'.[187] The GST legislation does not require money to change hands to provide consideration. Finally, in *Shirlaw v Malouf*, in respect of section 122, it was held that not to enforce an

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[185] *Currie v Misa* (1875) LR 10 Ex 153, 162.

[186] Nicholas C Seddon and Manfred Paul Ellinghaus, *Cheshire and Fifoot's Law of Contract* (LexisNexis Butterworths, 9th Australian ed, 2009) 167.

[187] *A New Tax System (Goods and Services Tax) Act 1999* s 9-75.

immediate payment of a debt and other non-monetary benefits was 'valuable consideration'.[188]

One method of structuring a succession plan is for the owners to own the insurance over a principal (cross-ownership model).[189] Under this model, when an owner leaves or an incoming owner enters the business, then an interest in the existing life insurance policy ('existing policy') is transferred to reflect the new business ownership. There may be no payment of money for the transfer of the existing policy.[190] The incoming owner, in return for becoming a party to the succession plan, receives an interest in the existing policy. Did the incoming owner provide no consideration for the interest in the existing insurance? 'Consideration', as used in the legislation, may have been provided in a number of ways, including those detailed below.

(a) Applying the Commissioner's Argument in TD 94/32

This approach is predicated on the assumption that the Commissioner's interpretation of the no consideration requirement espoused in above-discussed TD 94/32 is correct. When an incoming owner enters a business that is the subject of an existing succession plan, there are often two contracts to be entered into. The first is a purchase agreement where, in the words of Taxation Determination TD 94/32, an 'actual amount of money or other consideration' is usually paid for that interest in the business. The second agreement is a succession planning agreement where there may have been no 'actual amount of money' paid as consideration.[191]

The transfer of a life insurance policy for no consideration provides a means of avoiding the CGT taxation impost. To gain the CGT exemption, the incoming owner must demonstrate that no consideration was paid in return for receiving the interest in the existing life policy.[192] It is, therefore, necessary for the incoming owner to

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[188] (1989) 7 ACLC 1,043. The ongoing payment of the premium by a person acquiring the life insurance is unlikely to constitute a failure of the no consideration requirement. This is also the ATO's position in *Income Tax: Capital Gains: Can a Premium Constitute 'An Amount of Money or Other Consideration' Paid to Acquire Rights, or an Interest in any Rights, Under a Policy of Life Assurance for the Purpose of Subsection 160ZZI(3) of the Income Tax Assessment Act 1936?* TD 94/34, 21 April 1994.
[189] This is discussed in Chapter Six.
[190] The Commission also currently accepts this position in ATO TD 94/32 [4].
[191] Ibid.
[192] This is assuming that the replacement owner was not the 'original beneficial owner', in which case the 'original beneficial owner' would continue to satisfy the original beneficial owner requirement, regardless of whether consideration is paid.

prove that any 'actual amount of money' that changed hands was only for the payment for the interest in the business, not for the existing policy or for entering into the succession plan to which the existing policy relates.[193] A court would not need to interpret the term 'consideration' too broadly to take the view that any incoming owner acquired the rights under the existing policy in conjunction with the acquisition of the business interest. The transactions are interrelated and usually subject to and conditional upon each other.

Assuming the life insurance policy has value, a court may question why non-related or arm's length business owners would transfer a valuable asset for no consideration.[194] While the no consideration requirement applies irrespective of whether the parties are related or non-related, it may not be able to operate for non-arm's length parties because, still applying the Commissioner's approach in TD 94/32:

(a) The only relevant example in section 118-300(1), being Example 2, discusses the application of the exemption between spouses—who transfer the insurance for 'nothing'.[195] This may be common between married couples and family members, but is not so common between non-related business owners.

(b) Conversely, it is unusual for non-related or arm's length parties with 'comparable bargaining power' to transact for less than market consideration or no consideration.[196] Some courts have looked on such transactions with suspicion.[197] Even if the parties were seen to be not at arm's length because of their mutual interests in the same business, the courts also consider whether the parties are not dealing with each other at arm's length. Hill J in *Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT* stated:[198]

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[193] Cunningham and Keegan, above n 91.
[194] This expression is considered in Chapter Six.
[195] *ITAA 1997* s 118-300(1) Example 2. See fn 31 in Chapter Four above regarding Notes in *ITAA 1997*. The same holds true for Examples.
[196] *Bridgestone Australia Ltd v IR&D Board* (2003) 53 ATR 1126; (2003) 75 ALD 747; ATC 2166, where the Administrative Appeals Tribunal viewed as suspect a transaction between a company as a group of individuals.
[197] *A & C Sliwa Pty Ltd v FCT* [2011] AATA 390; (2011) ATC [10-184], which related to a revenue matter in which the court also considered a market appraisal to be incorrect.
[198] 91 ATC 4007, 4015.

> The first of the two issues is not to be decided solely by asking whether the parties to the relevant agreement were at arm's length to each other. The emphasis in the section [*ITAA 1936* section 26AAA(4)(b)] is rather as to whether those parties, in relation to the agreement, dealt with each other at arm's length. The fact that the parties are themselves not at arm's length does not mean that they may not, in respect of a particular dealing, deal with each other at arm's length. This is not to say that the relationship between the parties is irrelevant to the issue to be determined under the section. The distinction was pointed out by Davies J in connection with the similar words used in section 26AAA(4) of the Act in *Re Hains (dec'd); Barnsdall v FCT* (1988) 19 ATR 1352 at 1355; 88 ATC 4565 at 4568, in a passage, which with respect, I agree:[199]
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>> However, section 26AAA(4) used the expression 'not dealing with each other at arm's length'. That term should not be read as if the words 'dealing with' were not present. The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion.

If the legislation was intended to allow parties to a succession plan to be able to transfer insurance policies with no CGT consequences in this way, then it should be amended to provide for this unambiguously.

(b) Not Applying the Commissioner's Approach in TD 94/32

Putting aside that the incoming owner enters into a purchase of business agreement and pays, in the words of TD 94/32, an 'actual amount of money' for the business interest, the incoming owner will sign a succession planning agreement. The succession planning agreement, as a legally enforceable contract, provides for and sets out the terms of the succession plan. In the agreement, the incoming owner provides benefits and warranties that have value to the other parties. This valuable consideration is part of the bargain

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[199] Former *ITAA 1936* s 26AAA was repealed by Act No. 138 of 1994, s 67 without re-enactment. While part of the legislation, the taxpayer's assessable income was the profit from the sale of property or an interest in property purchased after 21 August 1973. This is where the sale occurred within 12 months of acquisition.

required before the existing parties agree to transfer an interest in the existing life policy. Without the signing of the succession planning agreement, the existing owners may be reluctant to transfer an interest in the existing policy to the incoming owner.

The assignment of the existing policy is based on the consideration in the form of the legal rights granted and acquired under the terms of the succession planning agreement. A court may take the view that this is valuable consideration (not 'no consideration') for the assignment of the existing policy. If this were the case, then the exemption is always lost where the transfer of the life insurance is predicated on the entering into a succession planning agreement.

5 The Life Insurance CGT Exemption Not Applying to TPD and Trauma

The third issue is the different treatment of life insurance when compared to TPD and trauma insurance. As set out in Chapter Three, for the purposes of the section 118-300 exemption, TPD and trauma policies do not equate to life insurance policies. Although many of the same legislative provisions cover them, TPD policies are treated as accident and disability insurance. The resulting differential tax treatment is that, while payouts under life insurance policies are granted, policies for TPD and trauma are not included under the section 118-300 CGT exemption.[200]

The ATO's reasoning behind this distinction can be traced back to the High Court decision in *National Mutual.*[201] Windeyer J held that accident and sickness policies differ from life policies, as they are more akin to 'fire, burglary and other miscellaneous policies'.[202] Important consequences flow from this distinction between life insurance and TPD and trauma insurance. In particular, although the three types of insurance used in succession planning are commonly bundled into the same policy, the ATO, as well as the courts, treat them as separate for the purposes of the CGT exemption.[203] The legislation, as currently defined by the High Court, presumes that three separate policies exist, only one of which (the life policy) can be potentially exempt under section 118-300.[204] However, the consequences of TPD and

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[200] However, the exemption in *ITAA 1997* s 118-300 (rather than *ITAA 1997* s 118-37) applies if the trauma or TPD eventuates in death. This is also the ATO's position as stated in ATO TD 2007/4.
[201] *National Mutual* Case (1959) 102 CLR 29.
[202] Ibid., 115.
[203] The expression 'bundled' is taken from *National Mutual* Case, 29.
[204] See Chapter Three.

trauma can be more financially crippling than death to the business, the outgoing principal, spouse and family. This can be the case because of the obligations and costs in maintaining the outgoing principal who is suffering from a disability. To equate TPD at the same level of 'fire' and 'burglary' in a succession planning context is not in accord with the taxation benchmark of equity and fairness.[205] It will be argued in Chapter Seven that there is insufficient justification for the different treatments.

E. Conclusion

By considering the deductibility of the insurance policies, income tax on the proceeds and the CGT exemption, this chapter identifies a number of inconsistencies. These are summarised below.

1 Deductibility of Insurance Premiums Inconsistencies

1. Commentators and the tax regulator 'struggle' to make sense of the application of the replacement principal for deductibility of the insurance in relation to succession planning as espoused by *Barnett v FCT*.[206]

2. There are different taxation treatments between the insurances—with trauma being treated differently from life and TPD for deductibility of the insurance premiums.

3. Depending on the entity used to hold the insurance (such as superannuation), some premiums may be deductible and the proceeds tax-free, even though the insurance policies and their purposes are the same. This is not in accord with the taxation benchmark of equity and fairness. Further, the ATO's approach as to the how it uses the purpose of the insurance to decide the income taxation implications is flawed and cannot be universally applied.

4. There is general inconsistency of the treatment of insurance on the capital account when compared to *Smith's* case in which the court stated that

[205] *National Mutual* Case (1959) 102 CLR 29, 115.
[206] (1999) 43 ATR 1221, 99 ATC 2444, [1999] AATA 950, 952.

insurance proceeds received during a period of total disability by the taxpayer were of a revenue character and therefore income.[207]

5 Evidence of legislative ambiguity can be seen in the inconsistency of the application of *Smith's* case in Taxation Rulings IT 2504 (taxpayer could not claim the interest for money borrowed to buy life insurance because if was of a private nature) and IT 2678 (interest charged on money borrowed by an employee to contribute to his or her superannuation fund is deductible, which is also of a private nature).[208] These inconsistencies are further highlighted by a comparison of ID 2004/661 (where mortgage protection insurance used to protect non-business loans was deductible) and PBR 94264 (interest paid on a main residence mortgage is not generally deductible). The inconsistency is that the purpose of the insurance is not always decisive as to whether the insurance premiums are on income or capital account.

6 The premiums payable for the insurance policies that are used to fund the succession plan are generally not deductible, as they are not necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income. However, the proceeds of some of the insurances may be treated as ordinary income and taxed accordingly. This is the case even though the Asprey Report held the view that 'compensation in a lump sum for personal injury ... [should] not [be] included as income'.[209]

7 Full deductibility of TPD in superannuation was removed without an intended change in the legislation or policy.

2 The Treatment of the Insurance Proceeds under Ordinary Income Concepts

8 For succession planning, the distinction between a loss of income and a loss of earning capacity can be difficult to establish with the circular nature of the application of *ITAA 1997* section 15-30. This is especially so where the

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[207] *Federal Commissioner of Tax v Smith*, 81 ATC 4114, (1981) 11 ATR 538, (1981) 147 CLR 578, (1981) 34 ALR 16, 20. That case cites as authority *Charles Moore & Co (WA) Pty Ltd v FCT* (1956) 95 CLR 344, 351. See also *Ronphibon Tin NL v FCT* (1949) 78 CLR 47, (1949) 8 ATD 431.
[208] ATO IT 2678 was withdrawn on 21 February 2007, see ATO IT 2678W.
[209] Asprey Report, above n 49, 64 [7.34].

proceeds are paid in more than one instalment. An amount received on the surrender of a policy (such as when a whole of life policy is 'cashed in') is treated as capital.[210] This is if the policy provides for the payment of a pension or annuity and not a fixed sum or allows the beneficiary the choice between a fixed sum and a pension.[211] In this instance, the pension payments may be wholly or partly assessable income.[212]

9 While a superannuation fund's trustee is generally treated the same as an individual taxpayer for income tax purposes, the insurance proceeds have different income tax consequences when owned in a superannuation fund.[213] This is the case even though the insurances have the same purpose.

10 Due to the poor legislative drafting of *ITAA 1997* section 118-37, as acknowledged by the tax regulator, the CGT exemption does not extend to superannuation funds for trauma and TPD. The ATO's attempt to overcome the poor legislative drafting, by making statements to say it will ignore the legislation to the taxpayer's benefit, instils a false sense of security in the taxpayer, because the courts will apply the law, rather than statements made by a regulator.

3 CGT on the Insurance Payout Inconsistencies

11 Counsel has argued in court cases that the 'provisions of the section [118-300(1) exemption] are ambiguous'.[214] For the exemption, in a succession planning context, the legislation is uncertain and could benefit from reform to satisfy the benchmark of simplicity.

[210] As set out in Chapter Two, whole of life insurance has an investment component that has a cash value payable by the insurance company.
[211] *ITAA 1936*, pt III div 2 sub-div AA.
[212] Where a life policyholder has control over the investment of the funds paid over as premiums, the income credited to the investor's account is assessable income of the investor derived at the time of or crediting ATO TD 92/166. However, this does not apply where the investor merely has the right to direct that the investment be placed in a particular class of investment operated by the insurer or investors generally.
[213] *ITAA 1936* s 272.
[214] See, for example, *Burke v FCT* (2004) ATC 2019. However, the court stated that the wording of the concession was not ambiguous for the purposes of the facts of the case.

12 The CGT exemption under section 118-300(1) only applies to life insurance policies and not disability policies such as TPD and trauma insurance. In the context of neutrality, the chapter has highlighted that life insurance and TPD/trauma insurance are treated differently without justification. The result is that the CGT treatment of life insurance is more favourably treated. This unreasonably affords different taxation treatment to different insurance and offends the Meade Committee's criterion of consistency.

13 The term 'original beneficial owner' is undefined and the cases, for the purposes of a succession plan, are collectively ambiguous. The confusion includes whether there term 'beneficial' relates to a trust relationship or merely 'economic utilisation'.[215]

14 Putting aside the general anti-avoidance provisions in *ITAA 1936* Part IVA, a person not subject to the terms of a succession plan can easily circumvent the no consideration requirement is section 118-300. In contrast, parties to a succession plan arguably always fail the requirement.

For these reasons, amendments the legislation should be considered, to rectify inconsistencies and provide certainty in this area of law.

Chapter Six considers further the effects of the CGT. This is in relation to the different insurance ownership models available in the structuring of a succession plan.

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[215] Allsop, above n 164.

CHAPTER SIX: THE DEMISE OF THE CROSS-OWNERSHIP INSURANCE MODEL AND THE FAILED QUEST FOR A REPLACEMENT

> ‘The second crucial aspect of succession planning is determining how the remaining owners will finance the acquisition of the outgoing interest. This issue is often overlooked, or it receives insufficient attention. However, it is important to consider financing, as the remaining owners may experience cash flow problems if they are required to finance an unexpected acquisition.
>
> One popular technique involves each of the owners taking out a life assurance policy; however, the structuring of the insurance can be an issue.’[1]

A. Introduction

The remaining owners need funds to purchase the outgoing owner’s interest in the business in the event of the outgoing principal’s, usually unexpected, death or disability. If the owners anticipate that they may not be able to obtain those funds, they may consider taking out life, TPD and trauma insurance.[2] The insurance provides a pool of money for the remaining owners to fund the purchase of the outgoing owner’s interest in the business. Commentators have divided the creation of a succession plan into two areas: how the plan is structured, and how the insurance is held. Chapter Five considered the succession plan’s structure and the ‘traditional’ mandatory buy-sell agreement, to highlight that legislative reform is desirable.[3] This chapter continues to highlight concerns with the succession plan by considering how the insurance is held in the succession planning agreement and the CGT consequences. This chapter will demonstrate that uncertainty in the legislation, inconsistent statements between the

[1] Lance Cunningham and Lucas Keegan, ‘CGT Aspects of Business Succession Planning’, *CGT Planning News* (Online, CCH Australia, 22 April 2005) ¶348.
[2] See, for example, Denis Barlin, *Restructuring for Business Succession and Buy/Sell Agreements: Tax Considerations* (Legalwise Seminar, NSW, March 2011) 6, where the succession plan is funded using life, TPD and trauma insurance, where ‘upon the death [or disability] of the outgoing principal, the remaining owners apply the payout from the insurance policy … to pay for the outgoing owner’s business interest’.
[3] The use of the word ‘traditional’ is taken from Matthew Burgess, *Passing Control of a Business on Insurable Events—Ensuring Fair Outcomes* (Taxation Institute of Australia, 18th National Tax Retreat, Sheraton Noosa Resort & Spa, Noosa, 19 August 2010) 13 and Brett K Davies and Ian S McEwan, *Colonial Guide to Business Insurance* (The Colonial Mutual Life Assurance Society, 1999) 32.

regulators and the curious, arguably unintended, outcomes of the legislation are an impediment to implementing a succession plan.

The simplest and most common way of holding the insurance, called the cross-ownership model, is first considered. It is argued that this model is superior to other models because it is both simple and easy to explain to the principals and their spouses. As noted before, while the cross-ownership model remains popular in the US, it has declined in popularity in Australia because of its adverse CGT consequences. The chapter then embarks upon a quest to find another model to hold the insurance to overcome the CGT issues identified in the cross-ownership model. The chapter demonstrates that not only are the other models by which the insurance can be held more complex and harder to explain to owners and clients, but they each come with their own adverse taxation outcomes. As the quest for a workable replacement model unfolds throughout the chapter, the research demonstrates that there is no way of holding the insurance in a succession plan that is simple, certain and tax efficient.

1 The 'Traditional' Way of Holding the Insurance in a Succession Plan

Until the introduction of CGT on 19 September 1985, most succession plans were structured as mandatory buy-sell agreements and the insurance was held using the cross-ownership model.[4] In the cross-ownership model, each owner holds life, TPD and trauma insurance policies over the other owners' principals.[5] For example, a business has three owners: *owner 1*, *owner 2* and *owner 3*. Insurance policies are jointly owned by *owners 1* and *2*, the proceeds of which are payable to them if *owner 3's* principal dies or is disabled. Similarly, *owners 2* and *3* jointly own an insurance policy over *owner 1's* principal. Finally, *owners 1* and *3* jointly own an insurance policy over *owner 2's* principal. When an outgoing principal dies or is disabled, the remaining owners receive the insurance proceeds directly from the insurance company.[6] Under the terms of the succession plan, the remaining owners are contractually bound to use the insurance proceeds to purchase the outgoing owner's business interest, therefore:

[4] See Burgess, above n 3, 13; and Davies and McEwan, above n 3, 32.
[5] A variation of the cross-ownership model is that each owner buys insurance for each of the other principals. For example, if there are five principals, there are 20 different insurance policies. See Mark R High, 'Drafting Buy-Sell Provisions in Shareholder Agreements' (2010) 19 *Business Law Today* 5, 32. This is not discussed further in this research, as it is not necessary to structure insurance policies in this way.
[6] Barlin, above n 2, 7.

1 **From the remaining owners' perspective**, they now have the right to acquire the outgoing owner's business interest and continue to operate the business, lose no management control to the outgoing owner and, because of the insurance proceeds to fund the purchase, suffer no loss of capital.

2 **From the outgoing owner's perspective**, the insurance proceeds provide full cash payment for the business interest, with the concern of managing or disposing of the business interest removed. (This can be important where the outgoing principal is unable to negotiate because of death or disability and the outgoing principal's spouse has little understanding of the business).[7]

Regrettably, because of CGT, '[t]he days of cross-ownership are almost gone'.[8] However, as mentioned above, commentators consider the cross-ownership model easier to explain to clients than the other models discussed in this chapter.[9] Cross-ownership made 'good business sense' to both the remaining owners and the outgoing owner.[10] The remaining owners saw that they were insuring themselves for their obligation to purchase the outgoing owner's interest in the business.

The principal's spouse may own or control the business interest. The High Court stated that a relationship between a businessperson and spouse may be such that:[11]

> often the woman, may well leave many, perhaps all, business judgments to the other spouse. In that kind of relationship, business decisions may be made with little consultation between the parties and with only the most abbreviated explanation of their purport or effect.

[7] As set out in Chapter One, Part B: Scope, the insurance proceeds, market value of the business interest and agreed sale price are the same.
[8] Bernie O'Sullivan, *Estate & Business Succession Planning 2011–12* (Taxation Institute of Australia) 349 [19-105].
[9] High, above n 5, 32.
[10] Peter Bobbin, *Business Succession Planning—Making Sure It Survives Even If You Don't* (Taxation Institute of Australia, Sheraton on the Park Hotel, 20 November 2001) 7.
[11] *Garcia v National Australia Bank Ltd* (1998) 194 CLR 395, 403, per Gaudron, McHugh, Gummow and Hayne JJ. This was the case even though the wife was both a shareholder and director of the company. *In dicta*, Gaudron, McHugh, Gummow and Hayne JJ stated that relationships other than marriage might also have the same type of quality. For a discussion of this case see Anne Finlay, 'Garcia v National Australia Bank' (1998) 15 *Newcastle Law Review* 3, 2; Lyunden Griggs, 'Garcia v NAB and the Torrens System—Are They Reconcilable?' [2001] 6 *QUT Law Journal* 1, 76.

The grieving spouse may have learnt of the succession plan only after the death or disability. In a cross-ownership structure, the money received from the remaining owners is understood to be in return for the transfer of the business interest.[12] This is consistent with the performance of a sale agreement: the persons who receive the asset provide the payment.[13] Chesire and Fifoot call it the 'contemporaneous reciprocal exchange'.[14] Because of the model's simplicity, its inherent business sense and tax certainty, cross-ownership is a common succession planning model in the US.[15]

There are two CGT concerns relating to the cross-ownership model. First, there are potentially adverse CGT consequences when a life insurance policy is transferred between owners apart from the succession plan. Second, the CGT exemption provided by *ITAA 1997* section 118-300 for the life insurance is broader than the CGT exemption for TPD and trauma provided by section 118-37.[16] These issues are now considered.

(a) Insurance Policy Transfers When New Owners Enter the Business

A CGT issue with the cross-ownership model arises where the owners of the business change separate to the operation of a succession plan. For example, a principal, prior to any death or disability, may retire from the business ('retiring owner'). Together the owners successfully find an acceptable replacement owner ('replacement owner'). The retiring owner sells the business interest to the replacement owner. However, as the insurance is cross-owned, the retiring owner retains the ownership of the insurance policies over the remaining principals. If there is an intention to keep the succession plan on foot, the retiring owner can transfer the insurance policies to the replacement owner.

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[12] The owner of the business interest may be an entity other than a spouse. In that case, the principal or the spouse may control the entity by being, for example, an appointor of a family trust, holder of the units in a unit trust or a sole shareholder in a company.
[13] High, above n 5, 32.
[14] Nicholas C Seddon and Manfred Paul Ellinghaus, *Cheshire and Fifoot's Law of Contract* (LexisNexis Butterworths, 9th Australian ed, 2009) 94.
[15] This model is referred to in the US as a 'cross-purchase agreement': High, above n 5, 32. In the US, the two most common ways of holding the insurance are with cross-ownership or redemption agreements, in which the business itself holds the insurance policies. See, generally, AR Fantini, RA Esperti and RL Peterson, *Love, Money, Control: Reinventing Estate Planning* (Esperti Peterson Institute, 2004) 385 and J Kabaker, 'Life Insurance in Estate Planning' [2009] *Journal of Practical Estate Planning* 14; Russell J Fishkind and RC Kautz, *Estate and Business Succession Planning: A Legal Guide to Wealth Transfer* (John Wiley & Sons, 2002) 194.
[16] This is also discussed in Chapter Five.

As discussed in Chapter Five, as the ownership of the policies has changed, the replacement owner is not an 'original beneficial owner' for the purposes of the section 118-300 exemption. Thus, insurance proceeds received by the replacement owner do not benefit from the exemption.[17] Failure to gain the CGT exemption undermines the owners' ability to fund the succession plan using insurance. Additional insurance may need to be applied to cover the extra taxation impost. The insurance company may decline to increase the level of the insurance cover.[18]

As discussed in Chapter Two, the succession planning insurance—being life, TPD and trauma—are term insurances where the premiums are paid yearly.[19] Term insurance has no residuary value upon the cessation of the premium payments. However, the insurance company is generally liable to continue to provide the insurance while the premiums are paid. This is the case even though the insured is advancing in age or has medical conditions not known or in existence at the time of the original policies.[20] It is open for the retiring owner to cancel the existing policies and for the replacement owner to seek to obtain new policies with the insurance company. If successful, the replacement owner would then be an 'original beneficial owner' for the new life insurance policies. The CGT exemption on the proceeds under section 118-300 would thus be satisfied. However, there are potential challenges in applying for new life insurance policies. Fresh medical checks may be required. Higher premiums may be payable. A principal may no longer be insurable because of advancing age or medical conditions.

A life insurance broker, with a client in these circumstances, may approach the insurance company to cancel the current policies and enter into new, identical policies in the name of the replacement owner.[21] This is with the hope and expectation that the

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[17] This is unless the replacement owner satisfies the other s 118-300 exception, being the 'no consideration requirement', as set out in Chapter Five.

[18] As well as the increased financial burden, an increase in the insurance cover may not be possible because of the principal's age and medical condition, or because the maximum amount of insurance is already in place.

[19] Greg Pynt, *Insurance Law* (Lexis Nexis, 2nd ed, 2011) 181. It is noted that all three insurances can be 'bundled' together and sold as one policy.

[20] *Insurance Contracts Act 1984* (Cth) s 63. However, as to the common law see *Sun Fire Office v Hart* (1889) 14 App Cas 98, where the insurer can stipulate that the insurance can be cancelled unilaterally by the insurance company.

[21] To offer life insurance to the public requires an Australian Financial Services Licence granted by ASIC pursuant to *Corporations Act 2001* ch 7, which allows the person offering the insurance to use the terms 'insurance broker', 'insurance brokering' and 'life insurance broker'. See *Corporations Act 2001* div 2 pt 7.1 [761A].

insurance company would not conduct new medical checks or alter the yearly premiums. There are three potential risks with this strategy.

1 Upon the cancellation of the current policies, the insurance company may decline to approve the issue of new policies automatically. A contract of insurance is one of utmost good faith that requires 'community standards of decency and fair dealing'.[22] Other persons dealing with the insurance company would expect all persons applying for insurance to be subject to the same due diligence.[23] This may include a 'fresh duty of disclosure'.[24] Such a duty requires all parties to disclose to the others 'at the time of entering into the contract all material facts known to him or her'.[25] It may therefore be a requirement that the insurance company undertakes a complete assessment of the principals.[26] Some of the principals, who are now older, may still be able to obtain the insurance. However, additional contractual requirements and charges may apply. Alternatively, the amount of the insurance cover may be reduced.

2 The 'dominant purpose' of entering into the 'scheme', being the cancellation and then entering into fresh insurance contracts without medical checks and usual due diligence, is to enable the parties to obtain a tax benefit in connection with the scheme.[27] Hence, *ITAA 1997* Part IVA might apply. The tax benefit is the

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[22] Kenneth Sutton, *Insurance Law in Australia* (LBC Information Services, 3rd ed, 1999) 158; see also *Vermeulen v SIMU Mutual Insurance Association* (1987) 4 ANZ Ins Cas 60-812 [74,987].
[23] As to the obligations by the parties for new insurance policies, see *Lambert Cooperative Insurance Society Ltd* (1975) 2 LLR 485, 487 and *MMI (Australia) Ltd v Gibbs* [2001] WASCA 271 [28].
[24] Pynt, above n 19.
[25] Sutton, above n 22, 159.
[26] The insurance company may be entitled to avoid the contract if there has been non-disclosure. This was the case where an accident policy was renewed in *National & General Insurance Co Ltd v Chick* [1984] 2 NSWLR 86.
[27] *ITAA 1936* s 177D deals with Part IVA. The High Court has said that a 'scheme' is a word of wide import: *FCT v Peabody* (1994) 181 CLR 359, 383 and *FCT v Hart* (2004) 217 CLR 216 [87]. It could be argued that the anti-avoidance provision in Part IVA is not breached because there is potentially no taxation benefit if there is never an insurance payout. However, this argument is not sustainable under the authority of *AXA Asia Pacific Holdings Ltd v FCT* [2009] FCA 1427, where Jessup J, in explaining the decision in *FCT v Lenzo* (2008) 167 FCR 255, stated:

> In my view, *Lenzo* is authority for the proposition that the starting point under s 177C(1)(a) is one which the whole scheme identified by the Commissioner must be assumed out of existence. The question then arises: what then might reasonably have been expected to have been included in the assessable income of the taxpayer? Here the court is engaged in a 'prediction as to events which would have taken place' in the absence of the scheme: *Commissioner of Taxation v Peabody* (1994) 181 CLR 359, 385. The exercise thus postulated, in my view, is wholly one of fact-finding. A fact is not disqualified, a priori as it were, from consideration merely by reason of it having been an element of the scheme which was in place. To the contrary: what the taxpayer and his or her associates in fact did in the commercial circumstances which existed is likely to shed much light on what they would have done in the absence of the scheme, and in some cases to be, as a matter of prediction, elements of that counterfactual (Paragraph 118).

avoidance of CGT on the life insurance proceeds.[28] In *FCT v Consolidated Press Holdings Ltd (No. 1)*, the High Court held that the purpose of the adviser in the implementation of the scheme was relevant in that:[29]

> Attributing the purpose of a professional adviser to one or more of the corporate parties in the present case is both possible and appropriate. In some cases, the actual parties to a scheme subjectively may not have any purpose, independent of that of a professional adviser, in relation to the scheme or part of the scheme, but that does not defeat the operation of [*ITAA 1936*] section 177D.

The court may decline to allow the 'tax benefits' under Part IVA.[30] In this case, that part of the section 118-300 exemption dealing with the 'original beneficial owner' is not satisfied.

3 Finally, the insurance company may be liable for penalties as a promoter under *Taxation Administration Act 1953* ('*TAA 1953*') Division 290, together with the lawyer, adviser, accountant and the persons party to the succession plan in seeking the new insurance with the intention of minimising tax.[31] As to the

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[28] A review of the literature has found no cases that deal with this particular issue. In any event, each element of s 177D would need to be considered on the facts as required by *FCT v Peabody* (1994) 181 CLR 359. Cases that provide guidance include: *FCT v Spotless Services Limited* 96 ATC 5201, which considered how the scheme arose, including the method and procedure; *FCT v Sleight* 2004 ATC 4477, which held that the substance of the arrangement is considered over its form; and *Cooke v FCT* 2002 ATC 4937, which stated that a promoter's motivation is relevant.

[29] 207 CLR 235; 47 ATR 229, (2001) ATC 4343, 4360 [95], per the joint judgment of Gleeson CJ and Gaudron, Gummow, Hayne and Callinan JJ.

As to the ethical duties of accountants see *Accounting Professional and Ethical Standards Board—APES* 220 s 5.4, which states:

> A Member shall not promote, or assist in the promotion of, or otherwise encourage any tax scheme or arrangements where the dominant purpose is to derive a tax benefit and it is not reasonably arguable that the tax benefit is available under Taxation Law. Accordingly, a Member shall not provide advice on such a scheme or arrangement to a Client or Employer other than to advise that in the Member's opinion it is not effective at law.

As to legal practitioners' duty to uphold the law and give proper advice to clients, this is set out in each State and Territory. For example, *Victorian Bar Rules* Rule 109(d) states:

> Without derogating from common law principles and all statutory provisions governing the involvement of legal advisers in advice with respect to possible breaches of the law by a client, a barrister should adhere to the principles that a legal adviser may not advise clients as to the ways in which unlawful purposes may be achieved and should not be involved in suggesting or proposing methods of breaking the law (including methods of evading revenue laws).

[30] *ITAA 1936* s 177C. For a clear discussion on Part IVA, see GT Pagone, *Tax Avoidance in Australia* (The Federation Press, 2010) 48–9.

[31] Legal practitioners must be ever vigilant in not 'assuming the mantle of entrepreneurs' when advising on schemes. In *Leary v. FCT* (1980) 47 FLR 414, 434–435, Brennan J decided that:

> Entrepreneurial activity does not attract the same privilege nor the same protection as professional activity and the promotion of a scheme in which particular clients may be advised to participate is pregnant with the possibility of conflict of entrepreneurial interest with professional duty.

owners and principals to the succession plan being personally liable under the promoter penalty laws, *TAA 1953* Division 290 Schedule 1 targets promoters of tax avoidance and tax evasion schemes, rather than the participants in the schemes. However, this could include those parties to the succession plan who encourage the replacement owner to enter into the scheme. Under *ITAA 1936* section 318, those persons who may be liable for penalties under Division 290 include individuals, companies, partnerships, unincorporated associations, trusts and superannuation funds. To fall foul of the promoter penalties, the party must gain some 'consideration'.[32] Principals and owners, unlike professional advisers, are not charging a fee. However, the benefits contained in a succession planning agreement may constitute such 'consideration'.[33]

In summary, it is possible for owners, from time to time, to enter and leave the business outside a succession plan. Under the cross-ownership model, the replacement owner either fails to satisfy the 'original beneficial owner' test under section 118-300 or may be acting outside the law in entering into fresh contracts of insurance. That is the first CGT issue for the cross-ownership model.

(b) Life Insurance's Unworthy CGT Relatives: TPD and Trauma Insurance

The second issue is that the CGT exemption for life insurance is more generous to the taxpayer than to the exemption for TPD and trauma. As discussed in Chapter Two, for taxation purposes, trauma and TPD insurance are treated, under High Court authority, as accident or disability insurance.[34] They are not considered policies of

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As to financial advisers, the *Financial Planning Association's Code of Ethics and Rules of Professional Conduct* provides the rules in which advisers operate when providing services. Under these rules, advisers must observe high standards of honesty and integrity. Specifically, under *Rules of Conduct* Rule 101, an adviser cannot engage in any act or omission of a misleading, deceptive, dishonest or fraudulent nature.
As to the ethical duties of accountants, see *Tax Agent Services Act 2009*.
However, under *Taxation Administration Act 1953,* s 290-60(2) sch 1, the lawyer, adviser and accountant are not promoters if they merely provide independent and objective advice about a tax exploitation scheme, even if that advice provides alternative ways to structure a transaction, or sets out the tax risks of the alternatives. As to the promoter penalties, they are found in *TAA 1953* div 290 sch 1.

[32] 'Promoter' is defined in *TAA 1953* s 290-60(1) as:

> (1) An entity is a promoter of a tax exploitation scheme if:
>
> > (a) the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it; and
> > (b) the entity or an associate of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and
> > (c) having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.

[33] As to what constitutes 'consideration', this is discussed later in this chapter.

[34] *National Mutual* Case (1959) 102 CLR 29.

'life insurance'.[35] This is the case even though the three types of insurance may be 'bundled' in the same policy, used in the same succession plan and for the same purpose. Nevertheless, the section 118-300 exemption does not extend to TPD and trauma insurance.[36]

The less generous concession for TPD and trauma is set out in *ITAA 1997* section 118-37, which provides in part that:[37]

> (1) A capital gain or capital loss you make from a CGT event relating directly to any of these is disregarded:
>
> > (a) compensation or damages you receive for any wrong or injury **you** suffer in your occupation;
> >
> > (b) compensation or damages you receive for any wrong, injury or illness **you** or **your relative** suffers personally.

TPD and trauma proceeds can only take advantage of the exemption if they are 'compensation or damages' for a 'wrong or injury'. The Explanatory Memorandum stated that the section:[38]

> disregards the compensation payment in working out the net capital gain or net capital loss when it should be disregarding the capital gain a taxpayer makes on receiving a compensation payment.

As set out in Chapter Two, TPD and trauma are 'compensation' payments for a 'wrong or injury'. Both, therefore, come within the operation of section 118-37.[39]

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[35] Doug Sumner, *Taxation of Risk Products* (Norwich Union, Internal Publication, 1999) 9.
[36] This is unless the TPD or trauma events lead to death.
[37] *Taxation Law Amendment Act No. 4* (1999) repealed *ITAA 1997* s 118-15 as amended (itself originally replaced by *ITAA 1936* s 160Z(6A)) and replaced it with *ITAA 1997* s 118-37(3). [Emphasis added.]
[38] Explanatory Memorandum, *Taxation Laws Amendment Bill (No. 11) 1999* refers to the earlier section that *ITAA 1997* s 118-37 replaced. *ITAA 1997* s 118-15 was replaced by *ITAA 1997* s 118-37(3).
[39] The Commissioner in ATO, *Income Tax: Capital Gains: Is a Sum Obtained by a Taxpayer Under a Trauma Insurance Policy an Exempt Capital Gain Under Subsection 160ZB(1) of the Income Tax Assessment Act 1936?* TD 95/43, 9 August 1995 also accepts this interpretation. ATO TD 95/43 refers to an earlier equivalent section, being *ITAA 1936* s 160Z(6A).

The more generous section 118-300 exemption for 'life insurance' is less discriminatory. It exempts anyone, including individuals, partnerships, trusts and companies, provided they are the 'original beneficial owner'. In contrast, section 118-37 only exempts proceeds received by the injured person or 'you' if 'your relative' is the injured person.[40]

The owners, who own the insurance in the cross-ownership model, are not 'related' to the dead or disabled principal.[41] However, the TPD and trauma insurance proceeds are not exempt from CGT without achieving the higher standard set out in section 118-37.[42] Under cross-ownership, the payout ('compensation') is paid to the remaining owners who own the TPD and trauma policies.[43] This is not the injured principal who 'suffers' the 'wrong, injury or illness'.[44] The concession for TPD and trauma is, therefore, not available when the business succession planning insurance is cross-owned. The more restricted section 118-37 concession, when compared to that in section 118-300, leads to less flexibility on how TPD and trauma can be structured.[45]

Life insurance, TPD and trauma serve the same purpose in the succession plan. From the taxation benchmark of equity and fairness, the wider life insurance exemption should be extended to TPD and trauma. This suggested reform is developed further in Chapter Seven.

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[40] *ITAA 1997* s 995-1(1) defines a 'relative' of a person to mean:

> (a) the person's spouse; or
> (b) the parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of that person's spouse; or
> (c) the spouse of a person referred to in paragraph (b).

[41] The owners include entities, such as companies and trustees. They do not satisfy the definition of 'relative' because, as set out in Chapter One, the research is restricted to non-family businesses.

[42] The Commissioner also holds this view in ATO TD 95/43. In Greg Cahill, 'The ATO Statement of Principles in Relation to Buy-Sell (Business Succession Agreements)' [2001] *Financial Planner's Digest*, 6, it is pointed out that the *ITAA 1997* s 118-37 exemption would apply if the remaining owners were 'related' to the outgoing principal. However, for the purposes of the research, the owners are deemed to be unrelated, as defined in Chapter One.

[43] *ITAA 1997* s 118-37(1).

[44] Ibid.

[45] The Commissioner, in defence of the legislation, points out that 'life insurance' premiums are tax exempt in the hands of the insurance company. In contrast, the premiums from TPD and trauma are taxed in the hands of the insurance company. This may further compound the problem if it leads to the insurance company increasing the premiums charged for TPD and trauma policies, as compared to life insurance, to cover the higher tax burden. This would make TPD and trauma more expensive in addition to the CGT obligations.

2 Conclusion as to Cross-ownership Model Post 1985

The holding of the succession planning insurance using the cross-ownership model has two unfavourable CGT consequences. The section 118-300 exemption for 'life insurance' ceases to apply when the insurance policies change hands. Second, under the model, TPD and trauma do not satisfy the section 118-37 exemption. As indicated, because of these adverse CGT consequences, cross-ownership has fallen out of favour. Conversely, in the US, the cross-ownership model usually raises the fewest income tax planning problems.[46] In the US, the outgoing owner is generally deemed not to have made a capital gain upon the sale of the business interest to the remaining owners. This is because the income tax 'basis' (which is equivalent to a 'cost base' under Australian CGT legislation) in the business interest is its 'fair market value' on the date of death.[47] This may be deemed the sale price set by the agreement.[48] In the US, the remaining owners usually increase their income tax basis if the outgoing owner's business interest is paid for with the proceeds of insurance.

Since the introduction of CGT and its adverse effects on this model, there has been an ongoing quest to find a replacement to the 'traditional' cross-ownership model.[49] The quest begins.

B. The Quest for Alternatives to the Cross-ownership Model

Other models have been developed because of the above adverse effects of CGT on the cross-ownership model. Alternative ways of holding the insurance include self-ownership, insurance trust and superannuation.[50] As argued in this chapter, these models, while overcoming CGT deficiencies in the cross-ownership model, come with their own drawbacks. It will be further argued that, under the current taxation legislation, no model removes all taxation issues and complexity.

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[46] See generally, Fantini, Esperti and Peterson, above n 15.

[47] Kabaker, above n 15, 13.

[48] HM Zaritsky and SR Leimberg, *Tax Planning with Life Insurance* (Warren Gorham Lamont, 1992) [7-26].

[49] See Burgess, above n 3, 13; Davies and McEwan, above n 3, 32.

[50] There is also the potential for the insurance to be owned by the business itself. While this is a popular model in the US, known as redemption agreements, it is not commonly used in Australia. Further, when the business entity is a company, the insurance is 'trapped' in the company. In a share buy-back, the insurance may attract corporate tax rates and be treated as a dividend. This model of holding the insurance is not considered in this research.

1 Self-Ownership Model

An alternative to the cross-ownership model is for each principal to own his or her own insurance. This may be called the self-ownership model.[51] In this model, each principal contractually agrees, under the succession plan, to take out the insurance policy on him or herself. Upon death or disability, the outgoing principal (or his or her estate) receives the policy proceeds directly from the insurance company.[52] Under the terms of the succession plan, the insurance proceeds are deemed the outgoing owner's payment for the transfer of the business interest to the remaining owners. The remaining owners can require the outgoing owner to transfer the business interest to the remaining owners. This is without further (or arguably, any) payment.[53]

In the self-ownership model, the outgoing owner receives neither the insurance proceeds from the insurance company nor any payment from the remaining owners.[54] Instead, the outgoing principal receives the insurance proceeds from the insurance company.[55]

In contrast to the cross-ownership model, a risk of self-ownership from the outgoing owner's perspective is that it 'doesn't make sense' and is 'unfair'. As White has stated:[56]

> Another problem … arises if the compensation is paid to the relatives of a deceased estate on the one hand and the business interest is transferred to the remaining principals on the other hand for no consideration.

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[51] Barlin, above n 2, 7.

[52] Ibid.; Peter White and Ian MacPherson, *Business Succession Planning Buy/sell Agreements* (Taxation Institute of Australia, 20 September 2006) 13.

[53] As set out in Chapter One, for the purposes of this research, the insurance payout always equals the market value of the outgoing owner's interest in the business, which is also contractually the agreed value of the business.

[54] This is assuming that the outgoing principal does not own his or her interest in the business directly, but rather through another entity; for example, a spouse, trust or company.

[55] Self-ownership is the only model in which the outgoing principal (or the estate) receives the proceeds of the insurance directly from the insurance company. (In respect of the principal's superannuation fund owning the insurance policies, then, even in a self-managed superannuation fund where the principal may be a trustee, the superannuation fund, not the principal, receives the insurance proceeds). The insurance company makes the payment without any involvement or input from the remaining owners and '[t]here is no need to rely on another person to pass on the insurance proceeds to the injured party or their estate': O'Sullivan, above n 8, 352 [19-105]. This model gives the outgoing principal the greatest opportunity to receive the insurance proceeds.

[56] White and MacPherson, above n 52, 13; see also John Wheatley, *Business Succession Planning, Danger Time for Family Businesses* (Taxation Institute of Australia, 2001) 8.

This lack of a perceived payment by the remaining owners may be further aggravated if the outgoing principal's spouse was not involved in the negotiation and structuring of the succession plan. The spouse may hold the view that the business interest is being relinquished for 'free', as the remaining owners are paying no money.[57] The insurance proceeds for the loss of a dead or disabled husband or wife may be viewed as a private family matter, rather than the subject of a commercial agreement involving business owners. This is potentially reinforced when the insurance company, which may have no knowledge of the succession plan, directly provides the insurance proceeds to the spouse. The outgoing owner may refuse to sell or, from the remaining owners' perspective, want to 'double dip' by seeking additional consideration.[58]

In contrast, under the cross-ownership model, as the outgoing owner receives the 'proceeds from the remaining principals … they might consider to have been fairly dealt with …; [otherwise they] may be reluctant to dispose of the business interest'.[59] Even if there is no death, the outgoing principal may be unable to explain the intent of the insurance to his or her spouse because of health and disability issues. In such circumstances, the remaining owners may need to resort to the courts to enforce their legal rights under the succession planning agreement.[60] In the US, Reardon noted that as to enforcing a succession plan:[61]

> Your client may also know that even if you have a slam dunk win in a lawsuit, the enforcement of a judgment to collect money from an irresponsible party can be gruelling and costly.

(a) The Self-ownership Model 'Rights All Wrongs'

As demonstrated above, the cross-ownership model has two CGT shortcomings. The self-ownership model rectifies both. The first CGT concern with cross-owned insurance relates to life insurance. The section 118-300 exemption was lost when replacement owners entered the business and had transferred to them the retiring owner's interest in the insurance policy. This was because the replacement owner was not an 'original

[57] White and MacPherson, above n 52, 13.
[58] Wheatley, above n 56, 9.
[59] White and MacPherson, above n 52, 14.
[60] Peter Bobbin, *Successful Succession for Success* (Taxation Institute of Australia, 13th National Tax Intensive Retreat, 26 August 2004 and 2 December 2005) 9.
[61] Dennis Reardon, 'Ensuring the Transfer of Insurance Proceeds in a Buy-Sell Agreement [2011] *Journal of Financial Services Professionals*, 21.

beneficial owner'. This problem derives from the owners owning the insurance policy. Conversely, under the self-ownership model, the principal him or herself, at all times, owns the insurance policy. The 'original beneficial owner' requirement is therefore satisfied.

The second CGT concern with the cross-owned model relates to the TPD and trauma insurances. The section 118-37 exemption is not satisfied because the owners, who own the policies, are usually neither the person suffering the disability nor a relative of such a person. The TPD and trauma proceeds are, therefore, subject to CGT. In contrast, under the self-ownership model, the principal, who is the injured party, receives the insurance proceeds.[62] Under the self-ownership model, the section 118-37 exemption is satisfied.

While self-ownership satisfies the requirements for exemption as given above, the quest to find an alternative for the cross-ownership model is not satisfied. A new CGT issue arises under the self-ownership model. There is the ambiguity as to the existence of a cost base component for the remaining owners who acquire the outgoing owner's interest in the business. This is now considered.

(b) New CGT Issues: Missing the 'First Element' of the Cost Base for the Remaining Owners

In the cross-ownership model, the remaining owners receive the insurance proceeds directly from the insurance company. The remaining owners then use that 'money ... in respect of acquiring' the business interest.[63] Using the insurance proceeds, the remaining owners are able to establish a cost base under the 'first element'.[64] A cost base is important to the remaining owners because, when they dispose of that interest in the business, the cost base may reduce the capital gain.[65] The accessibility of this part of

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[62] Alternatively, the principal's estate receives the proceeds from the insurance policy. For the purpose of this research, it is assumed that the beneficiaries of the estate are 'relatives', as that term is used in *ITAA 1997* s 118-37.
[63] This is part of the requirements of the 'first element' of a cost base contained in *ITAA 1997* s 110-25(2).
[64] Tax is calculated on the 'net' capital gain. It is assumed, for the purposes of this section, that the asset is a CGT asset under *ITAA 1997* div 104. What constitutes a CGT asset is considered in Chapter Five. *ITAA 1997* s 102-5 defines the concept of 'net' as used in this context as applied in a five-step process, which includes the reduction of the capital gain by the cost base.
[65] If a CGT asset is acquired before 21 September 1999, then the cost base may be indexed for inflation: *ITAA 1997* s 115-30 and div 114.

the cost base may not be available to the remaining owners in the self-ownership model, as discussed below.[66]

Five 'elements' comprise a cost base under *ITAA 1997* section 110-25. The first element of a cost base is set out in section 110-25(2):[67]

> (2) The first element is the total of:
>
> > (a) the money you paid, or are required to pay, in respect of acquiring it; and
> >
> > (b) the market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).

In the cross-ownership model, because the remaining owners own the insurance policy, they receive the insurance proceeds directly from the insurance company. The remaining owners then pay that money to the outgoing owner in exchange for the business interest. For example, the insurance payout is $100 and these proceeds are received by the remaining owners. The purchasers, as the remaining owners, pay the $100 to the seller, being the outgoing owner.[68] In the words of section 110-25(2) as to the first element of the cost base, the payment is the 'money' that the remaining owners are 'required to pay in respect of acquiring' the business interest.[69] The first element of the cost base is, therefore, $100.

Immediately after the transaction, the remaining owners may decide to sell the business interest to a replacement owner. The 'market value' of the business interest is $100.[70]

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[66] The taxable capital gain is potentially reduced by concessions available to the taxpayer, such as the CGT small business concession and discount for holding an asset for more than 12 months. This is a simplified version of how the CGT rules apply. The CGT consequences depend upon the actual circumstances.
[67] 'Note 2' at the end of the section states 'This element is replaced with another amount in many situations: see Division 112'.
[68] This is assumed in this research to be the market value to the seller (being the outgoing owner).
[69] *ITAA 1997* s 110-25(2).
[70] The High Court considered the ordinary meaning of 'market value' in *Spencer v The Commonwealth of Australia* (1907) 5 CLR 418, where Griffith CJ, 432, stated that:

> the test of value of land is to be determined, not by inquiring what price a man desiring to sell could have obtained for it on a given day, that is whether there was, in fact, on that day a willing buyer, but by inquiring: What would a man desiring to buy the land have had to pay for it on that day to a vendor willing to sell it for a fair price but not desirous to sell?

Isaacs J, 441, in the same case, further stated:

The replacement owner agrees to purchase from the remaining owners the business interest for $100.[71] As the remaining owners' cost base is $100, and the business interest is sold for $100, there is no capital gain on the disposal.[72]

However, if the outgoing owner 'gifts' the business interest to the remaining owners, then the remaining owners may lose the advantage of the first element of the cost base.[73] Without the first element of the cost base, when the business interest is immediately on-sold to the replacement owner for $100, the capital gain is the full sale price of $100.[74] The remaining owners now have a $100 capital gain on which CGT is calculated.

Under the self-ownership model, the insurance company pays the insurance proceeds to the outgoing principal.[75] Neither the outgoing owner nor the remaining owners receive the proceeds from the insurance company. Pursuant to the terms of the succession plan, the remaining owners pay no 'money' for the outgoing owner's interest in the business. Nor does the outgoing owner seek any 'money' from the remaining owners. The succession plan deems the self-owned insurance proceeds, received by the outgoing principal, to be the payment for the transfer of the business interest. Have the remaining owners, in the words of section 110-25(2), 'paid' for the business interest based on the bundle of rights and obligations that they provided in the succession plan? The word

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> to arrive at the value of the land at that date, we have … to suppose it sold then, not by means of a forced sale, but by voluntary bargaining between the plaintiff and a purchaser willing to trade, but neither of them so anxious to do so that he would overlook any ordinary business consideration. We must further suppose both to be perfectly acquainted with the land and cognisant of all circumstances which might affect its value, either advantageously or prejudicially, including its situation, character, quality, proximity to conveniences or inconveniences, its surrounding features, the then present demand for land, and the likelihood as then appearing to persons best capable of forming an opinion, of a rise or fall for what reasons so ever in the amount which one would otherwise be willing to fix as to the value of the property.

[71] As set out in Chapter One, the insurance proceeds are assumed to always be the market value, which is assumed to always be the agreed value under the succession plan.

[72] This is assuming that there are no other costs of acquiring the business interest such as transfer duty (stamp duty), accounting or legal costs, so that there are no further 'elements' to increase the cost base under *ITAA 1997* s 110-25.

[73] This is whether pursuant to a succession plan or otherwise.

[74] This is less incidental costs and other costs such as transfer duty. Such other costs under elements 2–4 may have otherwise provided a cost base and reduced the capital gain accordingly.

[75] The circumstances addressed in ATO, *Income Tax: Capital Gains: Can the First Element of the Cost Base of a CGT Asset in Subsection 110-25(2) of the Income Tax Assessment Act 1997 Include Money Paid or Property Given to an Entity Other than the One from Which the Asset Was Acquired?* TD 2003/1, 19 February 2003 do not apply because, as stated in ATO TD 2003/1 [1], 'the money or property still needs to have been paid or given in respect of the acquisition of the asset'.

‘paid’ is not defined in the taxation legislation. The *Macquarie Dictionary*, relevantly, defines the word as follows:[76]

> Paid means:
>
> 1 to discharge (a debt, obligation, etc), as by giving or doing something.
>
> 2 to give (money, etc) as in discharge of debt or obligation.
>
> 3 to satisfy the claims of (a person, etc) as by giving money due.
>
> 4 to defray (cost or expense).
>
> 5 to give compensation for.

A ‘payment’ by a third party insurance company—being an entity that is not a party to the succession plan and not related to the remaining owners—is unlikely to constitute a ‘payment’ for these purposes.[77] This view is supported with the use of the word ‘you’ in ‘money you paid’.[78] ‘You’ does not include an insurance company. It also does not include a related party to the outgoing owner, being the outgoing principal. The Commissioner has also followed this view in the ATO discussion paper.[79]

In seeking to provide meaning to the expression ‘paid’, it is compared to the expression ‘consideration’. In *Scully v FCT* (‘*Scully*’), the Full Federal Court noted, in an income tax assessment issue dealing with TPD, that the term ‘consideration’ is wider than ‘payment’.[80] The court stated:[81]

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[76] *The Macquarie Dictionary Online* (Macquarie Dictionary Publishers Pty Ltd, 2012) <http://www.macquariedictionary.com.au>.
[77] *ITAA 1997* s 110-25(2).
[78] Ibid.
[79] S Sorbello et al., *Discussion Paper in Relation to Buy-Sell (Business Succession) Agreements* (ATO, 2000) <http://civiclegal.com.au/Publications/3051ATODiscussionPaper-BuySell.pdf> 14.
[80] 98 ATC 4671; (1998) 98 ATC 4671. The case considered whether a payment constituted ‘consideration’ ‘in respect of’ a TPD payment under *ITAA 1936* ss 27A(1)(n) and 27G.
[81] Ibid., 4677.

> The expression 'consideration' is used to extend the paragraph to include a benefit which is not strictly a 'payment' but is a benefit in respect of which an estimation or valuation can be made as to its monetary worth.

Section 110-25(2) does not, however, use the wider expression 'consideration'; it uses the more restrictive word 'paid'.

While 'paid' suggests a narrower view, section 110-25(2) couples the word 'paid' with the term 'in respect of' when acquiring an asset. The term 'in respect of' is used a number of times in the taxation legislation.[82] As decided in *Scully*, the term 'in respect of' broadens the effect of the word 'for', in that:[83]

> The words 'in respect of personal injury' are to be given a meaning which extends beyond what would otherwise be included by use of the expression 'for personal injury'. While both expressions 'for' and 'in respect of' require a connection between the consideration and the injury, the expression 'for' denotes a more immediate connection. For example, an order of a court or tribunal awarding general damages for a broken leg could be said to be an award made for personal injury in the sense of being compensation for the disability arising from that injury.

However, even though the words 'in respect of' have a 'wide ambit ... [they] must reflect the context in which they are used and therefore have limits'.[84] A 'discernible and rational relationship' is still required.[85] Such a relationship is difficult to sustain under the self-ownership model. There are three reasons for this.

1 The outgoing principal receives the insurance proceeds irrespective of the succession planning agreement's existence or enforceability.

2 The promises in the succession planning agreement, while dealing with and referring to potential insurance payouts, are not sufficient to constitute property

[82] See, for example, *ITAA 1936* s 23AF for the exemption of certain income derived 'in respect of' approved overseas projects; see also *A New Tax System (Family Assistance) (Administration) Act 1999* s 71CAB and *ITAA 1936* s 26H as regards bonuses and other amounts received 'in respect of' certain short-term life assurance policies.
[83] *Scully v FCT* (1998) 98 ATC 4671, 4679.
[84] Ibid.; see also *Technical Products Pty Ltd v State Government Insurance Office* (1989) Aust Torts Reports ¶80-245, 68,622; (1989) 167 CLR 45, 47-48, as referred to in *Scully*, 4679.
[85] *Scully v FCT* (1998) 39 ATR 213; (1998) 98 ATC 4671, 4679.

or payment for the purchase of the outgoing owner's interest in the business. Authority for this proposition is based on *Australia and New Zealand Savings Bank Limited v FCT*.[86] This case dealt with the relationship and nexus between a contract and whether a separate event constitutes a 'capital sum'.[87] Hill J stated:[88]

> None of the factors relied upon by the learned trial judge in support of the conclusion that the 'capital sum' had not disappeared in my view and, with the greatest respect, supports the conclusion. The fact that the relationship between the annuity agreements and other documentation executed was 'intimate', while true, adds nothing to the analysis. It is undoubtedly correct that the annuity agreement must be construed in the light of the circumstances surrounding its execution, but there is nothing in any of the other documents executed at the same time that operated to alter the legal relationship between the investor and the annuity provider, as set out in the annuity agreement. The fact that the amount of the annuity might be recalculated having regard to the happening of contingencies which might affect the net after-tax return to the investor on its funds invested did not make the transaction one of loan, and it is of no materiality that the after tax return was calculated by reference to a formula which took into account a principal sum and partial repayments of it.
>
> None of the factors referred to above, alone or in combination, operated to convert the transaction into anything other than that which it was, namely a promise by the annuity provider to pay amounts periodically over a number of years in consideration of the payment by the investor of a purchase price. The transaction was not one of loan and the instalments when paid were paid as instalments of an annuity.

Similarly, the 'intimacy', as the expression is used by Hill J, of the succession plan and the insurance payout to the outgoing principal may not be sufficient to

[86] (1993) 25 ATR 369, (1993) 114 ALR 673, (1993) 42 FCR 535, 93 ATC 4370.
[87] Ibid.
[88] Ibid., 4390.

convert the insurance payout into a 'capital' payment by the remaining owners to the outgoing owner.[89]

3 Finally, from a review of the cases that consider the expression 'in respect of', there is insufficient causality,[90] between the insurance proceeds provided by an insurance company and the notion of 'the money you paid, or are required to pay, in respect of acquiring' the business interest.[91]

In contrast to the cross-ownership model, it is likely that the self-ownership model will not provide the remaining owners with a first element of a cost base when they acquire the business interest from the outgoing owner. However, an exemption to deem a first element of a cost base may be available. This is now considered.

(c) The Search for a 'Replaced' Cost Base—Market Valuation Rule

Section 110-25(2) Note 2 states that the first element of the cost base can be 'replaced with another amount'.[92] One such 'replacement' is the 'market value', as provided in *ITAA 1997* section 112-20(1), which states, in part:

> (1) The first element of your cost base and reduced cost base of a CGT asset you acquire from another entity is its market value (at the time of acquisition) if:
>
> > (a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:
> >
> > > (i) CGT event D1 happening; or

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[89] *Australia and New Zealand Savings Bank Limited v FCT* (1993) 25 ATR 369, (1993) 114 ALR 673, (1993) 42 FCR 535, 93 ATC 4370, 4390.

[90] The cases considered include: *Case 28/97*, 97 ATC 32; *Case R12*, 84 ATC 165; *Curtain World Pty Ltd v DFCT* 99 ATC 2020; *DFCT v. Steele* 87 ATC 5050; *FCT v Slade Bloodstock Pty Ltd* (2007) ATC 5276; *Knowles & Associates Pty Ltd v FCT* (2000) ATC 4151; (2000) 44 ATR 22; *Nelson v Inspector-General in Bankruptcy* 97 ATC 4338; *Slade Bloodstock Pty Ltd v FCT* (2006) ATC 2348, (2006) 64 ATR 1050, [2006] AATA 666; *Starrim Pty Ltd v FCT* (2000) ATC 4460, (2000) 44 ATR 487, [2000] FCA 952; *State Government Insurance Office v Rees* (1979) 144 CLR 549; *Thiel v FCT* (1990) 64 ALJR 516, (1990) 94 ALR 647, (1990) 90 ATC 4717, (1990) 21 ATR 531, (1990) 171 CLR 338; *Westpac Funds Management Ltd v Chief Commissioner of State Revenue (NSW)* (2008) ATC [20-069], (2008) 74 ATR 159, (2008) 74 NSWLR 566, [2008] NSWSC 1245.

[91] Section 110-25(2).

[92] See fn 31 in Chapter Four above regarding Notes in *ITAA 1997*.

> (ii) another entity doing something that did not constitute a CGT event happening; or
>
> (b) some or all of the expenditure you incurred to acquire it cannot be valued; or
>
> (c) you did not deal at arm's length with the other entity in connection with the acquisition.

(d) Incurring Expenditure

As to paragraph (a), the remaining owners ostensibly do 'not incur expenditure to acquire' the outgoing owner's interest in the business. However, the remaining owners have committed in the succession plan for their principals to self-insure. Under such cases as *Jones v Skinner,*[93] *McCaughey v Commissioner of Stamp Duties*[94] and *Minister of State for the Army v Dalziel*,[95] expenditure on the insurance premiums may be the giving of property. This may be sufficient to be 'expenditure' for the purposes of section 112-20(1). Further, under *Marren v Ingles*, it may constitute the provision of consideration.[96]

Paragraph (a), however, would seem to apply to acts of kindness, donations and the making of charitable gifts. A commentator provided this example of the market value substitution rule:[97]

> In a gesture of generosity before he died, Franklin gave Abraham a block of land. The land is valued at $120 000 at the date of the gift. The first element of Abraham's cost base is $120 000.

Another commentator gave the example of the operation of the rule as a father giving his daughter shares as a gift.[98] From a review of the literature, there are no examples of

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[93] (1836) 5 LJ Ch 90.
[94] (1945) 46 SR (NSW) 192.
[95] (1944) 68 CLR 261.
[96] [1980] 3 All ER 95.
[97] CCH Tax Editors, *Australian Federal Tax Reporter* (CCH Australia Ltd, Daily Online Update) [153-580]. However, compare this with the ATO's view that a lottery prize falls within paragraph (a) in ATO, *Income Tax: Capital Gains: Exemption Of Certain Gains And Losses: Betting and Lottery Winnings*, IT 2584, 10 May 1990.

this exemption operating other than to acts of kindness and gifts between family members.

The remaining owners promise to the outgoing owner in the succession plan to apply for and maintain the insurance policies. *ITAA 1997* section 108-5(1) couches the definition of a CGT asset in the widest possible terms as 'any kind of property, or a legal or equitable right that is not property'. Section 108-5(1) Note 1 includes, as an example, a right to enforce a contractual obligation. The outgoing owner has the right to enforce the carrying out of the promise.[99] The promise in the succession plan is potentially an asset for CGT purposes. The CGT asset, being the promise, may be sufficient to constitute 'expenditure' for the purposes of paragraph (a). It is therefore, at the very least, ambiguous whether paragraph (a) assists in providing a substituted cost base under section 112-20(1). The ATO discussion paper also concluded that the issue is not certain. It stated that:[100]

> the commitment to self-insure arguably constitutes the creation by the outgoing proprietor of 'contractual or other legal or equitable right(s) in' the other proprietors (CGT event D1) and therefore constitutes the giving of property or, at least, the giving of consideration.

Legislative reform is desirable to remove the uncertainty.

(e) The Remaining Owners not Dealing at Arm's Length

The market substitution rule is also available if section 110-25(2) paragraph (c) can be satisfied. Paragraph (c) is based on whether the remaining owners 'did not deal at arm's length' with the outgoing owner.[101] If that is the case, the first element of a remaining owners' cost base will be the 'market value' of the outgoing owner's business interests.

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[98] Robin Woellner et al., *Australian Taxation Law* (CCH Australia Ltd, 22st ed, 2012) [7-645].
[99] See *Milirrpum v Nabalco Pty Ltd & the Commonwealth of Australia* (1971) 17 FLR 141, 272.
[100] The ATO discussion paper refers to *Income Tax: Capital Gains: Capital Gains Tax Consequences of Earnout Arrangements*, TR 2007/D10. ATO TR 2007/D10 replaced Taxation Ruling TR 93/15. The draft ruling was never finalised and remains in place as a draft ruling. Compare, ATO National Tax Liasion Group, *Losses and CGT Sub-committee Minutes* (14 November 2007) Item 19, where, without giving reasons, there is a statement to the effect that the ATO's approach is wrong.
[101] *ITAA 1997* s 112-20(1). The expression 'not dealing with each other at arm's length' in respect of the substitution rule is considered in these cases: *Elmslie v FCT* 93 ATC 4964; *Granby Pty Ltd v FCT* 95 ATC 4240; *Barnsdall v FCT* 88 ATC 4565; *Collis v FCT* 96 ATC 4831 and *The Trustee for the Estate of the late AW Furse No. 5 Will Trust v FCT* 91 ATC 4007.

This is notwithstanding that no 'money' was 'paid' by the remaining owners to the outgoing owner for the business interest.[102] The question is: Do the remaining owners 'not deal at arm's length with the' outgoing owner as required by the market value substitution rule?

Some commentators have stated (incorrectly, it is submitted) that section 112-20(1) requires that both parties do 'not deal with each other at arm's length'.[103] Some taxation legislation does require that both parties need to 'deal' in a certain way. For example, former *ITAA 1936* section 26AAA(4) used the expression 'not dealing with each other at arm's length'.[104] However, this higher prerequisite does not apply to section 112-20(1). It only requires that the person acquiring the asset 'not deal at arm's length' with the 'other entity'.[105] For the purposes of the market substitution rule, in a succession planning context, it is not relevant how the outgoing owner (as the 'other entity') deals with the remaining owners.[106] Rather, the test is only from the remaining owners' perspective on how they deal with the outgoing owner.[107]

A second factor is whether it is important to ascertain whether the remaining owners are at arm's length with the outgoing owner. While this is not the test, it may help identify how the remaining owners deal with the outgoing owner. For example, the remaining owners may not be at arm's length with the outgoing owner, but still deal as if they are at arm's length 'in connection with the acquisition'.[108] Similarly, the remaining owners may be at arm's length with the outgoing owner, but still not deal with the outgoing owner on an arm's length basis 'in connection with the acquisition'.[109] Such relationships and the nature of 'dealing' were considered in *Elmslie v FCT* ('*Elmslie*').[110] In that case, the court considered the expression 'not deal at arm's length'

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[102] *ITAA 1997* s 110-25(2).
[103] See, for example, the CCH commentary, *Australian Capital Gains Tax Planner* [30-790].
[104] Former *ITAA 1936* s 26AAA was repealed by Act No. 138 of 1994, s 67 without re-enactment. For the application of former *ITAA 1936* s 26AAA(4) see *Barnsdall v Federal Commissioner of Tax* 88 ATC 4565. When operative, the section only applied to a sale of property, or an interest in property, occurring before 25 May 1988. The disposal of such property after 25 May 1988 is subject to *ITAA 1936* pt IIIA (Capital Gains and Capital Losses).
[105] *ITAA 1997* s 112-20(1).
[106] Ibid.
[107] Ibid.
[108] *ITAA 1997* s 110-25(2).
[109] Ibid.
[110] (1993) 26 ATR 611, (1993) 118 ALR 357, (1993) 46 FCR 576, 93 ATC 4964.

for the purposes of the market substitution rule under the precursor of section 112-20(1).[111] Wilcox J stated:[112]

> 'not dealing with each other at arm's length' ... is different to 'not at arm's length', which concerns the nature of the relationship.

Similarly, in *Barnsdall*, the court stated, '[T]hat term should not be read as if the words 'dealing with' were not present.[113]

Hill J, in the *Furse Will Trust* case ('*Furse*'), stated that not only can the relationship between the parties be relevant, but he also decided that:[114]

> What is required in determining whether parties dealt with each other in respect of a particular dealing at arm's length is an assessment [of] whether in respect of that dealing they dealt with each other as arm's length parties would normally do, so that the outcome of their dealing is a matter of real bargaining.

In *Barnsdall*, the parties' relationship to whether they were at arm's length is elevated to a fundamental part of the process of ascertaining how the parties are 'dealing'. The case decided that:[115]

> Section 26AAA(4) used the expression 'not dealing with each other at arm's length'. … The Commissioner is required to be satisfied not merely of a connection between a taxpayer and the person to whom the taxpayer transferred, but also of the fact that they were not dealing with each other at arm's length. A finding as to a connection between the parties is simply a step in the course of reasoning and will not be determinative unless it leads to the ultimate conclusion.

The determining of the relationship of the remaining owners to the outgoing owner, which is a necessary 'step in the course of reasoning', will now be considered.[116]

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[111] The former legislation was *ITAA 1936* s 160ZH(9).
[112] *Elmslie v FCT* (1993) 26 ATR 611, (1993) 118 ALR 357, (1993) 46 FCR 576; 93 ATC 4964, 4977.
[113] *Barnsdall v FCT* (1988) 19 ATR 1352, 1355; 88 ATC 4565, 4568. This quotation is also part of a quotation used in Chapter Five of this research.
[114] (1990) 21 ATR 1123, 91 ATC 4007, 4015.
[115] *Barnsdall v FCT* (1988) 19 ATR 1352, 1355; 88 ATC 4565, 4568.

As set out in Chapter One, for the purposes of the present research, the owners are deemed not to be related by marriage or common ancestry.[117] They are merely in business together. The remaining owners have their own families and 'loved ones'.[118] Generally, such classes of persons would not include a commercial business partner, such as an outgoing owner. In a family business, parents may desire that their children continue with the business when they are gone. In contrast, a prime motivation of a succession plan is the prompt removal of the outgoing principal and his or her family from the business upon the principal's death or disability.[119] Dr Anthony Fantini calls non-family business partners 'outsiders';[120] and Darling has stated that:[121]

> a partnership buy and sell agreement is not a donative or beneficent agreement, assuming it is not between persons who are not natural objects of each other's bounty.[122]

There may be respect and trust between business partners. However, they generally act in an arm's length capacity when compared with how business owners deal with their own spouses and children. In *Granby Pty Ltd v FCT*, Lee J stated that 'at arm's length' means that the parties to a transaction acted severally and independently in forming their bargain.[123] His Honour considered that the relationship between the parties and their conduct in 'entering into' the transaction are relevant to whether they have dealt with each other at arm's length.[124] He went on to say that, if the parties are at arm's length, then it usually follows that they will have dealt with each other at arm's length.[125]

It is necessary to look at the bargain struck by the parties to the succession plan. The remaining owners are not getting for 'free' the outgoing owner's business interest. This is in the sense that the outgoing owner is not benevolently handing over the business

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[116] Ibid.
[117] As to ancestry and blood relationships, see *Re Lanyon, Lanyon v Lanyon* [1927] 2 ch 264.
[118] As to the use of the expression 'loved ones', see *Australian Competition and Consumer Commission v Murray* [2002] FCA 1252, (2002) ATPR [41-899].
[119] This motivation is explored in Chapter Two.
[120] Fantini, Esperti and Peterson, above n 15, 378.
[121] SR Darling, 'Buy and Sell Provisions of Partnership Agreements (1949) 29 *Oregon Law Review*, 286.
[122] Ibid.
[123] (1995) 129 ALR 503, 506–507, (1995) 95 ATC 4240, (1995) 30 ATR 400, 403.
[124] Ibid.
[125] Ibid.

interest. The remaining owners are not being treated as charities or persons in need. The Commissioner has taken a different view. He has stated:[126]

> We do not accept the view that, because all parties to the buy-sell agreement have struck an ambit deal which submits each of them to the same risks and rewards (a commercial deal reached through real bargaining), all transactions arising under the agreement will be arm's length transactions.

As commentators have noted, if the Commissioner's position was rigidly applied, such a stance would represent a major concern, not just in succession planning, 'but for just about any other commercial dealing'.[127] In any event, the Commissioner seems to oscillate in his position because, in Taxation Ruling No IT 2540, in contrast to his above position, he stated:[128]

> It is accepted that the partners in a professional partnership will usually deal with each other at arm's length.

While the nature of a relationship is a question of fact to be considered in light of each succession plan's unique set of circumstances, many succession plans require that the agreed value of the business interest be re-assessed on a regular basis. This is so that the outgoing owner's business interest remains at market value. This suggests a desire for the parties to maintain an ongoing arm's length relationship. Further, it suggests that not only does an outgoing owner not want to 'give away' the business interest; the outgoing owner also wants to obtain full market value for the business interest. This is consistent with the parties acting at arm's length.[129]

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[126] Sorbello et al., above n 79, 12.

[127] Ian Esdaile, *A Selection of Taxation Issues for Consideration in Dealing With Business Succession* (Taxation Institute of Australia, 5th Annual Estate & Business Succession Planning Intensive, Sydney, 2004) 6.

[128] Para 30. However, the Commissioner seeks to distinguish the facts in the ATO Discussion Paper fn 19, by saying in the ATO Discussion Paper that IT 2540 deals with 'large' partnerships.

[129] As to the question of the ATO's view of the effect of the insurance and receiving fair value for the outgoing owner's interest in the business, see Sorbello et al., above n 79, 14, which stated:

> [The parties] will not be considered to have been dealing at arm's length if the amount that the outgoing proprietor receives on disposal of their business interests is merely insurance proceeds under a policy owned by the outgoing proprietor.

However, receiving full market value, of itself, may not be decisive in ascertaining the arm's length relationship. In *Barnsdall*, the Federal Court stated that:[130]

> Proof that a transaction was fair was not sufficient to show that the dealing was at arm's length. The term 'at arm's length' in section 26AAA(4)(b) is not to be construed as meaning 'for a fair price'.

Whether there was a price paid or the asset was acquired for less than, more than or at market value is not, in itself, decisive to whether the parties 'did not deal at arm's length' or did deal at arm's length. Rather, all the relevant facts need to be considered. The Commissioner's approach suggests that the fact that the remaining owners acquired the business interest for no money means, without further investigation, that the remaining owners 'did not deal at arm's length' with the outgoing owner 'in connection with the acquisition'.[131] Such a singular test is not supported by the courts. Rather, in *Furse*, the court looked at what the parties 'normally do' and whether the 'outcome of their dealings is a matter of a real bargain'.[132]

The reason that no money is paid is that the parties have entered into a commercial transaction. This is to the effect that the self-owned insurance proceeds provide full consideration for the transfer of the business interest to the remaining owners. The price struck as to the value of the business interest is the fair market value, calculated from time to time. As discussed above, while providing a fair market value is not conclusive to the arm's length relationship, it can exemplify the qualities of a 'real bargain', to which Hill J referred in *Furse*.[133]

In *Capricorn Diamonds Investments Pty Ltd v Catto*, the court stated:[134]

> Fair market value is commonly defined as the price that would be negotiated in an open and unrestricted market between a willing, knowledgeable, but not anxious buyer and a willing, knowledgeable but not anxious seller, acting at arm's length.

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[130] (1988) 19 ATR 1352, 1355; 88 ATC 4565, 4568, 4569.
[131] Sorbello et al., above n 79, 12.
[132] *The Trustee for the Estate of The Late Furse No. 5 Will Trust v FCT* (1990) 21 ATR 1123, 91 ATC 4007, 4015. See also *Barnsdall v FCT* (1988) 19 ATR 1352, 1355; 88 ATC 4565, 4568.
[133] *The Trustee for the Estate of The Late Furse No. 5 Will Trust v FCT* (1990) 21 ATR 1123, 91 ATC 4007, 4015.
[134] [2002] VSC 105 (10 April 2002) [177].

In similar terms, Lonergan, in *The Valuation of Businesses, Shares and Other Equity*, also considers the issue of 'arm's length' in relation to market value:[135]

> Market Value—the price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arm's length.

Depending on the facts, it is unlikely that the courts would decide that the remaining owners were 'not dealing at arm's length with' the outgoing owner 'in connection with the acquisition' of the business interest. In that case, the market valuation substitution rule would fail, and there would be no first element of the cost base.[136] At the very least, there is uncertainty as to how to interpret the legislation for the purposes of a succession plan. Legislative amendments are desirable to provide certainty. An amendment to the effect that the insurance constitutes consideration would provide such certainty.

(f) The Search for a 'Replaced' Cost Base—Using the Second Element

There may be a sense of despair when the remaining owners, caught in the self-ownership model, are told that there may be no first element of the cost base because no 'money' was 'paid' by the remaining owners to the outgoing owner for the business interest.[137] The outgoing owners are then told that there is also possibly no deemed cost base under the market substitution rule because their purchase of insurance for the remaining principals constitutes 'expenditure'.[138] If there is no 'money paid' for the business interest, but there is 'expenditure', then there may be an opportunity to create a second element of the cost base. This is based on their 'expenditure' in the purchasing of the remaining owner's insurance policies. If this were the case, the premiums paid for the remaining principal's insurance would constitute part of the cost base.[139] The second element, set out in *ITAA 1997* section 110-25(3), states:[140]

> The second element is the incidental costs you incurred. These costs can include giving property: see section 103-55.

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[135] Wayne Lonergan, *The Valuation of Businesses, Shares and Other Equity* (Allen and Unwin, 4th ed, 2003) 97.
[136] *ITAA 1997* s 112-20(1).
[137] *ITAA 1997* s 110-25(2).
[138] *ITAA 1997* s 112-20(1)(a), where paragraph (a) states 'you did not incur expenditure to acquire it'.
[139] This amount, generally, would not be substantial when compared to the proceeds of the insurance.
[140] *ITAA 1997* s 995-1 states that the term incidental costs 'has the meaning given by section 110- 35'.

ITAA 1997 section 110-35 sets out 11 incidental costs.[141] These are predominantly transaction costs, such as professional and legal costs and the costs of the conveyance.[142] A review of this list suggests that it is unlikely that the 'expenditure' by the remaining owners to purchase insurance for the remaining principals would fall within the scope of section 110-35 as an incidental cost.

(g) Conclusion as to the Self-ownership Model

The self-ownership model successfully addresses the two CGT concerns in the cross-ownership model. First, the life insurance exemption under section 118-300 is satisfied because the 'original beneficial owner' remains the outgoing principal. Second, while CGT is payable on the TPD and trauma proceeds when the insurance is cross-owned, it is exempt in the self-ownership model.[143] The exemption is satisfied because the insurance proceeds are paid to the injured party, being the outgoing principal.[144]

However, the self-ownership model arguably leaves the remaining owners without a substantial cost base when they acquire the outgoing owner's interest in the business. The remaining owners have a potentially greater capital gain when they decide to

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[141] *ITAA 1997* s 110-35(1) states, in part:

> (1) There are a number of incidental costs you may have incurred. Except for the ninth , they are costs you may have incurred:
>> (a) to acquire a CGT asset; or
>> (b) that relate to a CGT event.
>
> (2) The first is remuneration for the services of a surveyor, valuer, auctioneer, accountant, broker, agent, consultant or legal adviser. However, remuneration for professional advice about the operation of this Act is not included unless it is provided by a recognised tax adviser.
> (3) The second is costs of transfer.
> (4) The third is stamp duty or other similar duty.
> (5) The fourth is:
>> (a) if you acquired a CGT asset - costs of advertising or marketing to find a seller; or
>> (b) if a CGT event happened - costs of advertising or marketing to find a buyer.
>
> (6) The fifth is costs relating to the making of any valuation or apportionment for the purposes of this Part or Part 3-3.
> (7) The sixth is search fees relating to a CGT asset.
> (8) The seventh is the cost of a conveyancing kit (or a similar cost).
> (9) The eighth is borrowing expenses (such as loan application fees and mortgage discharge fees).
> (10) The ninth is expenditure that:
>> (a) is incurred by the head company of a consolidated group or MEC group to an entity that is not a member of the group; and
>> (b) reasonably relates to a CGT asset held by the head company; and
>> (c) is incurred because of a transaction that is between members of the group.
>
> (11) The tenth is termination or other similar fees incurred as a direct result of your ownership of a CGT asset ending.

[142] Section 110-35(1)(a) and (b) provide an introduction to the 11 incidental costs. The two paragraphs are couched in wide terms: '(a) to acquire a CGT asset; or (b) that relate to a CGT event'. However, the listing of the 11 types of incidental costs serves to limit the inclusivity of these two paragraphs.

[143] The CGT exemption is provided by *ITAA 1997* s 118-37.

[144] Alternatively, it is paid to the outgoing owner's estate.

dispose of that interest in the business. This, together with the uncertainty in the law, demonstrates that the self-ownership model fails to address the CGT issues adequately.

2 Superannuation Ownership Model—The Missing Purpose

(a) Introduction

With the ambiguity of the cost base issue for self-ownership, the quest to find a tax certain and effective way of holding the insurance continues. The superannuation ownership model is now considered.[145] In this model, the insurance is owned by the superannuation fund of which the principal is a member.[146] The superannuation fund pays the insurance premiums to the insurance company.[147] Upon the principal's death or disability, the insurance proceeds are paid directly to the superannuation fund for the member's benefit.[148] As with the self-ownership model, the insurance proceeds are deemed the outgoing owner's payment for the transfer of the business interest. Again, as in the self-ownership model, there is ambiguity as to whether the remaining owners can establish a cost base under the first element.

Upon the outgoing principal's death or disability, the remaining owners can require the outgoing owner to transfer the business interest to the remaining owners.[149] Correspondingly, the outgoing owner can require the remaining owners to accept the transfer of the business interest. This is without any further payment other than the proceeds of the insurance policy derived by the superannuation fund. However, superannuation funds are restricted in their choice of investments.

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[145] It is assumed, for the purposes of this research, that a superannuation fund is a complying superannuation fund within the meaning of *Superannuation Industry (Supervision) Act 1993* (Cth) s 45. Non-complying superannuation funds have their own taxation issues, and they are not considered in this research.

[146] Wheatley, above n 56, 9 notes that the 'employer entity pays the premiums and claims the deduction'. The employer or the member may also contribute to the superannuation fund, which may then be used to pay the insurance premiums. The costs of the insurance premiums can also be met by the assets already in the superannuation fund.

[147] It may be difficult for a principal to qualify for insurance. This may be because of the principal's age, medical condition or *plumbeus* activities, such as smoking. Group superannuation plans and employer-sponsored superannuation funds often provide certain levels of insurances without the need of medicals or consideration to pre-existing ailments. Persons unable to get insurance may be able to obtain insurance through such superannuation funds.

[148] If the member has died then '[b]inding death benefit nomination can be used to ensure that the proceeds of the policy pass as intended by the principal': White and MacPherson, above n 52, 17. However, such binding nominations generally expire and need to be re-established every three years. The situation may be different for a self-managed superannuation fund.

[149] As stated in Chapter One, for the purposes of this research, the price agreed between the parties as to the outgoing owner's business interest, the market value and insurance payout are the same amount.

(b) Can a Superannuation Fund Own Insurance Policies?

The *Superannuation Industry (Supervision) Act 1993* ('*SIS Act*') section 62 requires that the 'sole purpose' of superannuation is for the 'core purposes' set out in section 62(1), or for an 'ancillary purpose'. Section 62, in part, states:

> (1) Each trustee of a regulated superannuation fund must ensure that the fund is maintained solely:
>
> > (a) for one or more of the following purposes (the core purposes):
> >
> > > (i) the provision of benefits for each member of the fund on or after the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged …
> > >
> > > (iv) the provision of benefits in respect of each member of the fund on or after the member's death, if:
> > >
> > > > (A) the death occurred before the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged; and
> > > >
> > > > (B) the benefits are provided to the member's legal personal representative, to any or all of the member's dependants, or to both.

While 'core purposes' centre on the member's retirement and death, an 'ancillary purpose' includes providing employment termination insurance and 'disability superannuation benefit'.[150] It also includes salary continuance on a member's cessation

[150] As defined in *ITAA 1997* s 995-1(1) the:

> disability superannuation benefit' means a superannuation benefit if:
>
> > (a) the benefit is paid to an individual because he or she suffers from ill-health (whether physical or mental); and
> >
> > (b) two legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the individual can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

of work because of ill health.[151] This raises two issues. First: Are life, TPD and trauma policies acceptable assets for superannuation funds? Second: Are they acceptable assets for superannuation funds when used for the purposes of funding a succession plan?

The first question is whether acquiring life insurance, TPD and trauma in superannuation funds accords with the sole purpose test. *ITAA 1997* section 295-465 provides deductions for 'current or contingent liabilities' for a 'death and disability benefit'.[152] *ITAA 1936* section 267(1) defines a 'death or disability benefit' for a member of a superannuation fund as a benefit if it is for:[153]

1 the member's death;

2 a member, in the event of permanent disability; or

3 the member, by way of income, during a period when the member is unable to perform the normal duties of the member's employment, being a period of either two years or a longer period, as approved.

Life insurance caters for the event of 'death'.[154] As to TPD, *SIS Act* section 62(1) states that an 'ancillary purpose' allows payment of benefits on cessation of work due to total and permanent incapacity.[155] As set out in Chapter Two, TPD insurance is payable when the member can no longer work.[156] Subject to the individual circumstances of a

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[151] In APRA, Superannuation Circular No. III.A.4 (1998) Australian Prudential Regulation Authority [7], it was stated that 'the test is the legislative expression of the retirement income objective which is the key rationale for superannuation savings'.

[152] *ITAA 1997* s 259-460(1); see also *ITAA 1997* s 259-460(2), which states, in part, that a:

> fund can also deduct the amount it could reasonably be expected to pay in an arm's length transaction to obtain an insurance policy to cover it for that part of its current or contingent liabilities to provide benefits referred to in s 295-460 for which it does not have insurance coverage.

Such taxation issues are specifically discussed in Chapter Five.

[153] For the 2007/2008 and later financial years, *ITAA 1936* s 267 was replaced by *ITAA 1997* s 995-1, which contains the definitions used for tax purposes (*Act 15 of 2007*).

[154] *Superannuation Industry (Supervision) Regulations 1994*, Regulation 6.01, sch 1, Item 102.

[155] Ibid., Regulation 6.01, sch 1 gives the conditions of release of benefits, described in Item 103 as 'permanent incapacity' and in Item 109 as 'temporary incapacity'.

[156] Legislation is being considered for non-SMSFs to be required to offer life and TPD insurance cover as a default. As to SMSFs, if the legislation proceeds without amendment, then the SMSF trustee must consider the life and TPD insurance needs of members as part of the fund's investment strategy. See Australian Treasury Department, *Stronger Super* (The Treasury, September 2011) <http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/key_points.htm> in which legislation is being considered that will require APRA-regulated superannuation funds to provide life and TPD insurance by default, with an opt-out available for the member.

superannuation fund member, life and TPD insurance are assets permissible under the *SIS Act* for a superannuation fund.[157]

(c) Trauma—'an Unreasonable Diversion'?[158]

Where a person suffers TPD, they cease working.[159] In contrast, a trauma claim is paid regardless of whether the insured person ceases work. This may not comply with the purposes of superannuation, as the member may continue to work after the trauma event. There is no case authority on point. However, the Australian Prudential Regulation Authority (APRA), in Superannuation Circular number III.A.4, considered the appropriateness of trauma insurance. It stated that trauma insurance was:[160]

> An unreasonable diversion of contributions as premiums for the contingent trauma cover would be difficult to reconcile with the sole purpose test and the fundamental retirement objective of superannuation.[161]

Payment of trauma premiums may not be consistent with the sole purpose test because, even after the proceeds are paid under the policy, the member may recover and return to work.[162] Commentators have also stated that trauma is not an asset available for superannuation funds.[163]

While acknowledging APRA's Circular, the ATO took a different stance.[164] The ATO Interpretative Decision ID 2002/371 stated that trauma does comply with the sole purpose test and is a permissible asset for a superannuation fund.[165] Similarly, the

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[157] See also Woellner et al., above n 98.
[158] APRA, Superannuation Circular No. III.A.4 [47].
[159] This is discussed in Chapter Three.
[160] APRA, Superannuation Circular No. III.A.4 [47]. This Circular replaced Superannuation Circular III.A.4, entitled 'The Sole Purpose Test and Ancillary Purposes' (Insurance and Superannuation Commission, October 1995). APRA regulated all matters relating to superannuation and the *SIS Act* at that time. Since 8 October 1999, the Commissioner of Taxation was added as a regulator under the *SIS Act*, primarily to regulate self-managed superannuation funds.
[161] APRA, Superannuation Circular No. III.A.4 [47].
[162] Ibid., [46].
[163] For example, Wheatley, above n 56, 9.
[164] See ATO, *Superannuation—Part IX Taxation of Superannuation Entities—Superannuation Fund Expenses—Trauma Policy*, ID 2002/371, 9 September 2007, 2, Note 2, which stated:

> Paragraphs 43 to 47 of APRA Circular No. III.A.4 make reference to the amount of contributions applied to purchase trauma insurance policies. They state that it is considered an unreasonable diversion of contributions as premiums for the contingent trauma cover would be difficult to reconcile with the sole purpose test and the fundamental retirement objective of superannuation.

[165] ATO ID 2002/371 does not expressly consider the sole purpose test. Rather, it considers the taxation deductibility of the premiums, posing the question: 'Is a deduction available to the trustee of the

ATO's Self-Managed Super Fund Determination (SMSFD) 2010/1 considered the question: 'Can a trustee of a self-managed superannuation fund purchase a trauma insurance policy in respect of a member and still satisfy the sole purpose test in section 62 of the *SIS Act*?'[166] In answer to the question, SMSFD 2010/1 stated that trauma insurance does not breach the sole purpose test and:[167]

> Yes, a trustee can still satisfy the sole purpose test provided any benefits payable under the [trauma] policy:
>
> - are required to be paid to a trustee of the self-managed superannuation fund (SMSF);
> - are benefits that will become part of the assets of the SMSF at least until such time as the relevant member satisfies a condition of release; and
> - the acquisition of the policy is not made to secure some other benefit for another person such as a member or member's relative.

In conclusion, while life and TPD polices are expressly permissible assets under the legislation, there is doubt as to whether the holding of trauma insurance in a superannuation fund conflicts with the sole purpose test.[168] Legislative change is desirable to remove the ambiguity.

(d) Can a Superannuation Fund Own Insurance Policies for Succession Planning Purposes?

Assuming the holding of life, TPD and trauma insurance policies by superannuation funds does not breach the sole purpose test, the second issue is whether the insurance policies are a permissible investment for the purposes of funding a succession plan. The insurance may be considered for the permitted purpose of providing benefits 'on or after

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complying superannuation fund under *ITAA 1936* s 279(1) in respect of premiums paid by the fund for a trauma policy?'

[166] The date of the Determination is 21 April 2010. Self-Managed Superannuation Funds Determinations are not legally binding on the Commissioner. This quotation is part of the Determination's title.

[167] ATO, *Self-Managed Superannuation Funds: Can a Trustee of a Self-Managed Superannuation Fund Purchase a Trauma Insurance Policy in Respect of a Member and Still Satisfy the Sole Purpose Test in Section 62 of the Superannuation Industry (Supervision) Act 1993?* SMSFD 2010/1 [1].

[168] See the above-discussed example of APRA, Superannuation Circular No. III.A.4, in this chapter.

the member's retirement from any business, trade, profession, vocation, calling, occupation or employment'.[169] However, as commentators have stated, the 'circumstances around obtaining the insurance may jeopardise the fund's ability to satisfy the sole purpose test'.[170]

While some commentators hold the view that owning insurance to fund a succession plan breaches the sole purpose test, there is no specific legislation or direction from the courts specifically on this point.[171] The regulators, APRA and the ATO, have not expressed a view. However, the ATO's SMSFD 2010/1 refers to a 'small business owner'.[172] It stated that it is permissible for a business owner to take out trauma insurance policies in a superannuation fund. However, the Determination does not mention or link the trauma insurance to any succession plan or other purpose. Rather, an example provided in SMSFD 2010/1 stated that the purchase of the trauma policy accords with the sole purpose test provided that:[173]

> There are no other benefits received by 'John' from the insurance company upon the trustee's purchase of the policy or upon the occurrence of the insured event.

As to the ATO's use of the expression 'no other benefits', the member or the member's associate does gain a 'benefit' unconnected with the superannuation fund.[174] The benefit is the superannuation fund providing insurance as the consideration required by the member to enter into a succession plan. This is part of a succession plan between the member and the other parties to the agreement. If the member (as a principal) dies or is disabled, then the insurance proceeds are deemed consideration. The insurance is the consideration for the purchase of the outgoing owner's interest in the business by the remaining owners.

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[169] The insurance may assist the member's executor realise full value for the deceased's assets, being an interest, but not necessarily directly in the business. See *ITAA 1997* s 259-460(1)(a)(i). This is where, for example, the business may be held by a company or a trust, which is then controlled by the outgoing principal's spouse. See *ITAA 1997* s 259-460(1)(a)(iv).
[170] White and MacPherson, above n 52, 17.
[171] Wheatley, above n 56, 9; White and MacPherson, above n 52, 17.
[172] SMSFD 2010/1 [10], Example 2.
[173] Ibid. This example is analogous to SMSFD 2010/1 [1], which stated 'the acquisition of the policy is not made to secure some other benefit for another person such as a member or member's relative'.
[174] A pt 8 'associate' of an individual includes a member's 'relative', such as a parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the member and his or her spouse. See *SIS Act* s 10.

The purpose of the superannuation fund's purchase of the insurance is to provide funds to finance obligations under an agreement that is outside the superannuation fund. In a potential breach of the sole purpose test, the member or the member's associate is receiving a benefit from the superannuation fund.[175] It is, therefore, uncertain whether maintaining an insurance policy for succession planning purposes satisfies the 'sole purpose test'. Wheatley has stated that '[t]he writers, Martin DeHaas and Brett Davies, have grave reservations over this model'.[176] This may lead to a breach of the sole purpose test resulting in civil penalties, orders and fines.[177] Nevertheless, since 2001, without any change to the taxation legislation, the holding of the insurance in superannuation 'has become increasingly popular'.[178] Further, a commentator has noted that while 'a number of organisations and specialists have received confirmation from the ATO in this area … there are no easily available statements publically available'.[179] From these comments, it may be the case that some insurance companies and commentators have obtained private rulings from the ATO that support the argument that superannuation funds are able to hold succession planning insurance. The lack of publically available statements and openness is not in accord with the taxation benchmark of simplicity and fairness. It is uncertain whether a superannuation fund can hold succession planning insurance.[180]

As to the potential breach of the sole purpose test, the professional advisers and member of the superannuation fund may perceive the risk of discovery by the ATO to be low. It is improbable that the superannuation fund's auditor or the ATO auditor will be able to link the succession planning agreement to the insurance in the superannuation fund. This is because the succession planning agreement is unlikely to be shown to such auditors. Further, neither the trustee of the superannuation fund (acting in that capacity) nor the insurance company enter into any agreement relating to the succession plan.

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[175] SMSFD 2010/1 [17] stated that:

> The sole purpose test in *SIS Act* s 62 requires exclusivity of purpose and therefore a trustee who maintains an SMSF for any other purpose contravenes s 62. Matters relevant to determining if the maintenance of an SMSF is in accordance with the sole purpose test include how fund assets are acquired and invested, how fund assets are employed, and what benefits are provided by the SMSF.

[176] Wheatley, above n 56, 9.

[177] *SIS Act* pt 21.

[178] Burgess, above n 3, 8.

[179] Ibid.

[180] See Michael Flynn and Miranda Stewart, *Death & Taxes: Tax-effective Estate Planning* (Thomson Reuters, 5th ed, 2012) 131–132, where they stated:

> It has been suggested in the past by some that a superannuation could own the buy/sell insurance, and possibly that premiums may be deductible if the life insurance policy is taken out through a superannuation fund: see Ingram P and Mitchell K, *Buy/Sell Agreements*, Taxation Institute of Australia seminar paper, 29 January 2004, 14 and recently, Davies B (CCH Weekly Tax Bulletin, Issue 37, 2 September 2011. However, caution is required as this raises issues as to the satisfaction of SIS requirements'.

Neither are parties to the agreement.[181] Both may have no knowledge of the succession plan or the purpose of the insurance. A taxation system that may promote disregard for the law is not in accord with the taxation benchmark of equity and fairness. Legislation is required to address these issues.

(e) Summary of the Superannuation Ownership Model

The superannuation ownership model has three deficiencies:

1. As with the self-ownership model, the remaining owners may gain no first element of the cost base.

2. Trauma insurance, whether part of a succession plan or not, may not be a permitted asset in which a superannuation fund can invest.

3. Using the insurance to fund a succession plan may fall foul of the sole purpose test.

The final alternative to the cross-ownership model is now considered.

3 Trust Ownership of Insurance—The Tax Burden on TPD and Trauma[182]

The final model to be considered is a trust. A trust separates the legal ownership of property or rights from the beneficial ownership. The legal owner, being the trustee, is obliged to deal with the trust property for the benefit of the trust's objects, being the beneficiaries, such as the business owners.[183] Professor Dale Pinto has noted that trusts are often used in estate and succession planning and in the administration of the estate after death.[184] Their versatility includes the ability to hold the insurance for a succession

[181] They are not parties to the agreement in those capacities.
[182] Burgess, above n 3, 10.
[183] Michael Evans, *Equity & Trusts* (Lexis Nexis Butterworths, 2003) 294.
[184] Professor Dale Pinto and D Karlinsky, 'Darwinian Evolution of the Taxation of Trusts: A Comparative Analysis' (2007) 10 *Journal of Australian Taxation* 2, 256, citing as authority B Marks, *Taxation of Trusts* (1980) v, 16.

plan. In this model, a trust is established where the trustee owns the insurance policies over each principal.[185]

Upon a principal's death or disability, the insurance company pays the insurance proceeds to the trustee, as the policy's legal owner. Commonly, the insurance trust deed directs how the proceeds (as trust property) are distributed to the beneficiaries.[186] Pursuant to the terms of the trust deed, the trustee distributes the insurance proceeds to the remaining owners.[187] The remaining owners use the proceeds to purchase the outgoing owner's interest in the business and thus establish a first element of the cost base. For example, the business has two owners. The insurance trust owns the insurance policies on each of the principals. A principal dies or is disabled and the proceeds of the policy are paid to the trustee of the insurance trust. The trustee distributes the proceeds to the remaining owner as required by the succession plan and the trust deed. The remaining owner uses the proceeds to purchase the outgoing owner's interest in the business.

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[185] There are generally two views as to who should be the trustee. Either the parties themselves are the trustees, or a professional trustee can be employed to hold the position. See, for example, *Re Gray and Australian Securities and Investments Commission* (2005) 86 ALD 230; [2004] AATA 1235, where a legal practitioner attempted to be a professional trustee for a succession plan's insurance trust without desiring to hold a financial planning licence. In the first instance, the owners (or their representatives) act as trustees. Where there is disagreement on the distribution of the insurance, the trust deed contains rules that bind the trustees. Therefore, professional trustees (who may be considered 'independent') are not required. Alternatively, those persons who charge to be a trustee by providing professional trustee services may argue that independent third parties, such as themselves, are to be preferred. Such professional trustees, they may argue, remove bias, procrastination and the opportunity for theft in the distribution of the insurance proceeds.

[186] There are other lesser-used models. For example, in the trustee nomination model, an insurance trust is created by each principal purchasing an insurance policy over his or her own life. They nominate the trustee to receive any proceeds under the policy. A similar model is a bare trust. The trustee, upon receipt of the proceeds, distributes the proceeds directly to the outgoing principal. This is deemed the outgoing owner's payment by the remaining owners. An example of this structure is the basis of the ATO, *Income Tax: Capital Gains Tax Consequences for a Beneficiary of an Insurance Trust Deed,* PR 2010/18. In this product ruling, each principal separately takes out an insurance policy that is held in the bare trust. The insurance applies for each individual principal as the sole beneficiary, who is absolutely entitled, as against the trustee, to the insurance policy and its proceeds. Each beneficiary's interest is vested and indefeasible and may be called for at any time. However, the ATO in *Income Tax: Capital Gains: Meaning of the Words 'Absolutely Entitled to a CGT Asset as Against the Trustee of a Trust' as Used in Parts 3-1 and 3-3 of the Income Tax Assessment Act 1997*, TR 2004/D25, 15 December 2004 took a narrower view of what constitutes a bare trust as to absolute entitlement. See also ATO, *Private Binding Ruling* PBR 30018. Burgess, above n 3, 10, points out that:

> In many respects, structuring the arrangement in this way effectively negates any benefit in using a trust arrangement in the first place, as the role of the trustee becomes at best marginal, despite the additional costs of them acting.

Bare trusts have similar attributes to the self-ownership model. They are not discussed further in this research.

[187] Barlin, above n 2, 8.

(a) The Cross-ownership Model Assessment

As discussed previously, the cross-ownership model, following the introduction of CGT, has two main issues. First, there is no CGT concession if the life insurance policy is transferred from one owner to another. This is because the incoming owner is not the 'original beneficial owner'.[188] The trust ownership model overcomes this problem. It allows the owners to change in number and composition without altering the ownership of the life insurance policies. The trustee of the insurance trust holds the life insurance as the 'original beneficial owner'. This is the case although the class of beneficiaries, being the owners, changes.[189] This avoids the loss of the CGT exemption on the life insurance.[190] The section 118-300 exemption is not generally lost for life insurance, as there is no change in the ownership of the policy when owners enter and leave the business outside the operation of the succession plan.

The second concern with the cross-ownership model is that the proceeds of TPD and trauma insurance are payable to the owners. However, to gain the CGT concession, the proceeds must be paid directly by the insurance company to the insured 'person' or a 'relative' of the insured person.[191] The trust model fails to deal appropriately with this problem. The insurance company pays the TPD and trauma proceeds, being the 'compensation', to the trustee of the insurance trust.[192] The trustee, as the taxpayer, does not suffer the wrong or injury and is not 'related' to the insured person.[193]

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[188] This is as required by *ITAA 1997* s 118-300.

[189] The effect of the *ITAA 1997* s 104-10(2) Note confirms that there is no change in the ownership of a CGT asset, even if there is a change of trustee. The Note states:

> Note: A change in the trustee of a trust does not constitute a change in the entity that is the trustee of the trust (see section 960-100(2)). This means that CGT event A1 will not happen merely because of a change in the trustee.

[190] A resettlement of the trust can occur if the trust's objects (such as beneficiaries, including the principals and owners) change. A resettlement leads to a disposal of the trust's assets for CGT purposes. A resettlement would trigger a CGT event. For example, CGT Event E1 occurs where, subject to other conditions, there is a 'creation of a trust over a CGT asset by declaration or settlement' as set out in *ITAA 1997* s 104-55(1). The High Court held that this is a question of 'continuity' in *Federal Commissioner of Tax v Commercial Nominees of Australia Ltd* [2001] HCA 33, 35; (2001) ATC 4336; (2001) 47 ATR 220; (2001) 75 ALJR 1172; (2001) 179 ALR 655; (2001) 22(10) Leg Rep 42. A resettlement is generally avoidable if the trust deed contains a sufficiently expansive definition of the owners and principals, and if that class is left open. See *Davidson v Armytage* (1906) 4 CLR 205, *Davidson v Chirnside* (1908) 7 CLR 325, *CSD (NSW) v Perpetual Trustee Company Ltd* (Quigley's Case) (1926) 38 CLR 272, *Wedge v CS (Vic)* (1940) 64 CLR 75, *Buzza v CS (Vic)* (1951) 83 CLR 286 and *CSD (NSW) v Buckle* 98 ATC 4097, as referenced by White and MacPherson, above n 52, 16, fn 49.

[191] See *ITAA 1997* s 118-37(1).

[192] Ibid.

[193] If a bare trust existed, the exemption may be available under the conduit principles of *ITAA 1997* s106-50. However, if the trust is discretionary in nature, it is not eligible for the exemption.

(b) Conclusion as to the Insurance Trust Model

An advantage of the insurance trust is that there is one owner of the insurance, this being the trustee.[194] There is, therefore, centralised control for the payment of premiums and collection and distribution of the proceeds. The value of the centralised control may be at the expense of the complexity of the trust structure. Darling stated, as to the US experience:[195]

> The disadvantages of the trustee plan are that it costs money, it appears complicated, it is often confusing to the partners, and it may be the straw that breaks the camel's back in attempting to create a buy and sell arrangement.

The insurance trust model satisfies the section 118-300 CGT exemption for 'life insurance' because the original beneficial owner always remains the same. However, the model fails to protect the TPD and trauma from CGT because the injured party or his or her relative does not receive the proceeds. The quest to find a replacement for the cross-ownership model using the insurance trust, therefore, fails.

C. Conclusion

Succession planning for small business is faced with a number of tax-related obstacles. The previous two chapters have identified the taxation issues that arise with the operation of the succession plan. This chapter has considered different models in which to hold the insurance, to identity whether any of these models represents a best option. It was concluded that none of the options considered is ideal, due in large part to the ambiguity in the legislation pertaining to succession plans. The chapter concludes by considering how the legislation measures up to the taxation benchmarks of simplicity, efficiency and equity.

1 Simplicity for Taxpayer and Regulator

The research demonstrates that the simplest way to structure the insurance is via the use of the cross-ownership model. It makes better business sense, especially to the outgoing principal's spouse. However, there is ambiguity as to the legality of the creation of fresh

[194] Burgess, above n 3, 10.
[195] Darling, above n 121, 298.

life insurance policies and potentially no CGT relief for trauma and TPD. In response, more complex and harder to explain models have been developed. One alternative is the self-ownership model. However, ascertaining the first element of the remaining owners' cost base in this model is problematic. In addition, the uncertainty of a 'replaced' cost base in this model provides further evidence of ambiguity in the legislation.[196]

Another example of uncertainty is the regulators expressing conflicting opinions as to whether trauma is an acceptable investment for a superannuation fund. In regards to the superannuation model, there is ambiguity in the legislation and no public statement by the regulators as to whether using insurance to fund a succession plan falls foul of the sole purpose test. Some commentators claim, based on private communications with the regulators, that the use of succession planning insurance in a superannuation fund is within the sole purpose test. The ambiguity and uncertainty coupled with private communications is not in accord with simplicity.

2 Economic Efficiency and Encouraging Economic Growth[197]

Efficiency requires that the taxation system be as neutral as possible. This is so that trade and commerce are not unjustifiably hindered. Each alternative model fails to provide an acceptable alternative to the cross-ownership model. The complexity of the rules creates an additional barrier for owners desirous of creating a succession plan. Without a succession plan, the prospects of survival of the small business may be diminished.

The taxation system has 'economic opportunities and incentives' and with this there can be harmful 'substitution effects'.[198] This chapter has demonstrated that the taxation system can discourage insurance being held externally to superannuation. Premium affordability may be a key motivator that attracts the principals to hold the insurance in

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[196] There is, therefore, a risk that the remaining owners will have a potentially bigger capital gain when the remaining owners themselves decide to dispose of that interest in the business. Similarly, if the insurance is held in a superannuation fund, the first element of the cost base for the remaining owners is potentially lost.

[197] Review of Business Taxation, *A Strong Foundation: Discussion Paper 1: Establishing Objectives, Principles and Processes* (John Ralph, Chair) xviii stated:

> The pre-eminent economic challenges for Australia remain those of lifting its sustainable growth performance and enhancing job creation. A more efficient business tax system can contribute vigorously to those goals by redirecting business energy.

[198] JE Meade, *The Structure and Reform of Direct Taxation: Report of a Committee* (JE Meade, Chair) (1978) 7.

superannuation.[199] However, the proceeds of the TPD and trauma insurance may not be accessible to the member after the business interest has been transferred.[200] The proceeds may be trapped in the superannuation environment and not be available for the member's personal use, such as for rehabilitation and the replacement of lost income.

3 Equity and Fairness—The Distributional Effects

Pursuant to the taxation benchmark, wherever possible, the owners should be treated equally irrespective of which insurance model has been adopted.[201] However, there is inconsistent and ambiguous taxation treatment of the insurance proceeds depending on which model is used to hold the insurance. With cross-ownership, the CGT relief on the life insurance is lost when owners enter and leave the business and the life insurance policies are transferred to the replacement owner. The self-ownership model, in contrast, has no requirement for fresh insurance policies. This is the case even though the same insurance is held for the same purpose.

In this chapter, a quest was undertaken to discover a way of holding the insurance that overcame the taxation issues in the cross-ownership model. The three considered replacements—namely, self-ownership, superannuation and insurance trusts—although rectifying some or all of the cross-ownership model's failings, in turn fail to satisfy the taxation benchmarks. The research has contended that legislation ought to apply with simplicity, efficiency and equity. However, this chapter has demonstrated that the law is none of these. As discussed in the next chapter, legislative reform may be desirable to allow the simple cross-ownership model to be again accessible to small businesses. Legislative reform could remove both the uncertainty as to the operation of the legislation and the adverse taxation issues found in this model. The next chapter suggests some reforms to overcome these concerns.

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[199] Trauma premiums, while not generally tax deductible, might be perceived to be more attractive than payment of trauma premiums from after tax dollars outside superannuation.

[200] Any payout remains in the superannuation fund until the member meets a condition of release. A member may also satisfy a condition of release where the member is permanently incapacitated. A member is permanently incapacitated where a superannuation fund trustee is reasonably satisfied that the member is unlikely, because of physical or mental ill health, to engage in gainful employment for which the member is reasonably qualified by education, training or experience. Therefore, suffering a trauma condition is not necessarily a condition of release. If the design of the trauma policy is such that it is unlikely that the trustee of the superannuation fund can release the proceeds of the trauma payment to the member after receipt from the insurance company, this may breach the sole purpose test. See also APRA, Superannuation Circular No. III.A.4.

[201] Australia's Future Tax System Review (Ken Henry, Chair), *Australia's Future Tax System: Report to Treasurer* (Released 2 May 2010) 7.

CHAPTER SEVEN: RECOMMENDATIONS FOR THE REFORM OF BUSINESS SUCCESSION PLANNING IN AUSTRALIA

> 'The issue of business succession is an important issue for all privately owned businesses. While it is important to ensure the compatibility of the ownership team, it is equally important to ensure each of the owners can access the value inherent in their share of the business. Careful planning can allow both objectives to be satisfied. Even greater care is necessary to ensure that the plan does not produce an unexpected tax liability.'[1]

A. The Problem Reviewed and the Value of it being Solved

Small businesses in Australia employ 38 per cent of the workforce and pay nearly $12,000 million in income tax per financial year.[2] Unlike larger businesses, which may have a hierarchy of management, when a principal dies or is disabled, the small business may be at a greater risk of failing. Chapter Two has demonstrated the problems that can arise if a succession plan, funded by insurance, is not established. A documented succession plan that is fully funded by insurance can provide greater certainty and increase the likelihood of the small business surviving after a principal's, usually unexpected, death or disability. The remaining owners are enabled by the insurance proceeds to acquire the outgoing owner's interest in the business. The outgoing owner is freed from the need to negotiate a sale of the business interest and receives a guaranteed cash payment from the insurance proceeds.

This thesis contends that the inconsistencies and vagueness in the relevant income taxation legislation require review by the legislature. For example, there is uncertainty

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[1] Lance Cunningham and Lucas Keegan, 'CGT Aspects of Business Succession Planning', *CGT Planning News* (Online, CCH Australia, 22 April 2005) ¶348.

[2] The definition of 'small business' is defined in Chapter One of this research; it excludes non-agricultural employees. The most recent statistics from the Australian Bureau of Statistics can be found in *Counts of Australian Businesses, including Entries and Exits, June 2007 to June 2009* 8165.0 (31 January 2012), see 'Table 3.9: Company net tax, by company size (micro and small), 2006–07', 41 and 'Table 5.1: Partnerships, by size (micro and small), 2006–07', 61. The net taxation paid by 'small business operators' in the 2006/2007 financial year was $11,973 million.

as to when the business interest is deemed to be disposed of under CGT event A1. Depending on the model, there is confusion as to when the insurance premiums are deductible. The CGT concession under *ITAA 1997* section 118-300 on the life insurance proceeds is generally lost if the insurance is cross-owned and there is a change of owners. Instead, if the insurance is self-owned or owned in a superannuation fund then the taxation impost does not arise. The remaining owners, however, risk losing the first element of the cost base for their purchase of the outgoing owner's interest in the business.

The confusion and effects of the CGT legislation have meant that the 'traditional' mandatory buy-sell agreement with the insurance being cross-owned has been abandoned.[3] This is the case even though it is considered by commentators to be the simplest structure and easiest to explain to clients. This may be particularly important where the outgoing principal's spouse, who may have had little knowledge of the succession plan, would expect to see a payment from the remaining owners before 'handing over' the business interest. This payment by the remaining owners is achieved when the insurance is cross-owned. It is not achieved when the insurance is self-owned or already in the outgoing principal's superannuation fund.

As discussed, in the US, the mandatory buy-sell agreement using the cross-ownership model remains the dominant structure, while alternatives, such as options agreements, are rare.[4] The US, generally, has no tax on the insurance proceeds in an arm's length succession plan. Therefore, in the US, there have been no requirements for complex structures, such as put and call options and insurance trusts, in which to hold the insurance. Before the introduction of CGT, the mandatory buy-sell agreement was also the dominant succession planning structure in Australia, and if not for the CGT timing issues, it would likely have remained so. The research demonstrates that the legislation for succession planning is not in accord with the taxation benchmarks of simplicity and economic efficiency.

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[3] See Matthew Burgess, *Passing Control of a Business on Insurable Exit Events—Enduring Fair Outcomes* (Taxation Institute of Australia, 18th National Tax Retreat Taxation Institute of Australia, Sheraton Noosa Resort & Spa, Noosa, 19 August 2010) 13; Brett K Davies and Ian S McEwan, *Colonial Guide to Business Insurance* (The Colonial Mutual Life Assurance Society, 1999) 32.

[4] AR Fantini, RA Esperti and RL Peterson, *Love, Money, Control: Reinventing Estate Planning* (Esperti Peterson Institute, 2004) 385.

B. Proposed Reform

This research presents a systematic, historical and legal study of the taxation of insurance in business succession planning. The research, it is suggested, is unique in Australia in that it establishes taxation benchmarks based on the Meade (UK) and Asprey (Australian) reports and asks:[5]

1 Is the current approach to the taxation of insurance for succession planning simple, efficient and equitable?

2 If it is not, would a different approach be preferable?

In addressing both questions, five suggested reforms are considered to bring the taxation of the succession planning process closer to the ideals set by the taxation benchmarks. These reforms seek to alleviate the inconsistencies and deficiencies in the current taxation system. This is so that there is greater certainty and fairness and thus a greater incentive for small business owners to enter into succession planning agreements. These suggested reforms to the legislation, as they relate to a business succession plan, are:

1 The time of the CGT event A1 on the disposal of the outgoing owner's interest in the business be deemed the time the transfer of the business occurs pursuant to the succession plan.

2 The CGT concession provided to life insurance be extended to TPD and trauma, by including TPD and trauma in the definition of life insurance.

3 The insurance be deductible as to the premiums and free of income tax, including CGT, on the proceeds under all succession planning models, rather than just under the superannuation model.

[5] The taxation benchmark is established in Chapter One. JE Meade, *The Structure and Reform of Direct Taxation: Report of a Committee* (JE Meade, Chair, 1978); Taxation Review Committee (Asprey, Chair), *Full Report* (AGPS, Canberra, 1975).

4 The definition of the sole purpose test be expanded to allow superannuation funds to invest in life, TPD and trauma insurance for the purposes of succession planning.

5 Irrespective of how the insurance is held, the remaining owners receive the first element of the cost base equal to the succession planning insurance proceeds.

The suggested reforms are limited to business succession planning and are now considered.[6]

C. The Date that the Agreement is 'Entered Into' is the Date of Death or Disability

There is uncertainty as to when, for CGT purposes, the succession planning agreement is deemed to have come into effect. The 'standard' or 'traditional' mandatory buy-sell agreement may no longer provide certainty as to the timing of the CGT event A1 under *ITAA 1997* section 104-10(3).[7] 'Despite years of suggesting the contrary', the ATO discussion paper re-interpreted the ATO's position on mandatory buy-sell agreements as to when they trigger a disposal of the business interest.[8] The change of position by the ATO further demonstrates the legislative ambiguity. The time of the CGT event is potentially the date the agreement is signed rather than the date of the principal's death or disability. This leads to three peculiar outcomes. First, the outgoing owner is required to amend taxation returns when the death or disability of the outgoing principal occurs.[9]

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[6] Some of the suggested reforms would not be applicable or required if others were implemented. For example, if there were taxation deductibility as to the insurance premiums and no taxation consequences on the payout, then it would inappropriate to allow, in all situations, the first element of the cost base. It would be unnecessary to implement the second reform, being the inclusion of TPD and trauma in the definition of life insurance.

[7] This is as discussed in Chapter Four. As to the use of the expression 'standard', see Burgess, above n 3, 13. As to the use of the expression 'traditional', see Davies and McEwan, above n 3, 32. Previously *ITAA 1936* s 160U(3) div 104 (where s 104-10 is situated) was inserted into the *ITAA 1997* by the *Tax Law Improvement Act (No. 1) 1998*, receiving Royal Assent on 22 June 1998 and taking effect from that date. Therefore, on 22 June 1998, s 160U(3) was replaced by s 104-10(3). s 104-10 was rewritten and the latest variation has only had effect from the 1999 income year.

[8] Burgess, above n 3, 12; S Sorbello et al., *Discussion Paper in Relation to Buy-Sell (Business Succession) Agreements* (ATO, 2000) <http://civiclegal.com.au/Publications/3051ATODiscussionPaper-BuySell.pdf> 7.

[9] *ITAA 1936* s 170 (10AA) allows the Commissioner to amend such returns without any time limit. This 'qualification', as stated in *ITAA 1936* s 170, overrides the general provision also found in *ITAA 1936* s 170, being 'The Commissioner may amend an assessment of an individual for a year of income within 2 years after the day on which the Commissioner gives notice of the assessment to the individual'. The Federal Court confirmed the Commissioner's power to amend an assessment at any time to give effect to

If the acquisition of the business interest and the signing of the mandatory buy-sell agreement are within 12 months of each other then, second, the outgoing owner loses the 50 per cent CGT discount.[10] This is the case even if the outgoing owner had owned the interest in the business for over 12 months. Finally, if the succession plan was signed before 20 September 1985, the outgoing owner is disposing of a pre-CGT asset that retains its pre-CGT status in the hands of the remaining owners. This is irrespective of how many years after 1985 the transfer to the remaining owners takes place. This is a taxation windfall for the remaining owners when they subsequently dispose of the business interest.

To deal with the unfavourable CGT effects, a number of variations to the mandatory buy-sell agreement were considered in Chapter Four. However, each of these variations posed its own problems. As to the first variation, being the condition precedent, the cases of *Meehan v Jones*[11] and *George v Roach*[12] demonstrate that the issue of whether a condition is a condition precedent or a condition subsequent in a succession planning context is a complex one, involving fine legal distinctions. There is a risk that the agreement could be 'entered into' when signed.[13] The second variation of the mandatory buy-sell is what commentators colloquially called the 'agreement to agree'.[14] While there are issues as to the enforceability of verbal agreements and the general anti-avoidance provisions in Part IVA, there is also a risk, under the High Court authority of *Sara Lee*, that the initial agreement, whether verbal or committed to writing, is, again, the date the agreement was signed.

In a complete abandonment of the mandatory buy-sell agreement, the research examined put and call options. As well as being more difficult to explain to clients than mandatory buy-sell structures, put and call options have three taxation issues. First, pursuant to *ITAA 1997* section 104-10, the timing for CGT event A1 can be either when the put and call option agreement is signed or when it is exercised. Second, while

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the specific CGT event timing rule in s 104-10(3) in *Metlife Insurance Ltd v FCT* 2008 ATC 20-025; 70 ATR 125, and on appeal (2008) ATC 20-049; 70 ATR 364.

[10] See *ITAA 1997* s 115-30. The discount is a different amount where the asset is held in a complying superannuation fund. The discount may not necessarily be available in different structures. Other conditions must be met, such as holding the asset for more than 12 months.

[11] [1982] 149 CLR 571.

[12] [1943] 67 CLR 253.

[13] Greg Cahill, *Succession Planning, Restructuring and Buy and Sell Agreements* (Taxation Institute of Australia, Integrated Estate and Financial Planning Day, 2002) 5.

[14] Burgess, above n 3, 9.

options are specifically listed as CGT assets in the note to *ITAA 1997* section 108-5, they are not defined by taxation legislation.[15] Pursuant to the authority of the Full Federal Court in *FCT v Guy,* the timing of the option for CGT purposes depends on its construction. It carries similar timing risks as the condition precedent structure.[16] However, in contrast to the condition precedent structure, as put and call options are separate capital gain assets, the third concern is whether the grant of an option, in itself, results in a capital gain for CGT purposes.[17] A further non-taxation related issue is the enforceability of the options against a deceased estate. This comes from a review of the decisions in *Carter v Hyde*[18] and *Ballas v Theophilos.*[19]

CGT is a broad-brush tax and, from the literature review, little consideration appears to have been given for succession planning in small business. However, the Government does consider CGT relief for specific circumstances. For example, it has given taxpayers the choice as to whether to claim water entitlement rollover relief to CGT events that happened in the 2005/2006 and later income years, as backdated from 2010.[20] More recently, the Government considered ameliorating the effects of CGT on a business merger involving the CGT rollover rules.[21]

Similarly, based on the taxation benchmarks, special treatment could be considered for succession planning structures as to the timing of the disposal of the business interest. Such treatment would allow the use of the mandatory buy-sell structure. To this end, the Government should consider amending the legislation so that the time of CGT event A1 for a succession plan is when the outgoing principal dies or is disabled.

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[15] *ITAA 1997* s 108-5, CGT assets:

> (1) A CGT asset is:
>
> (a) any kind of property; or
>
> (b) a legal or equitable right that is not property.
>
> (2) To avoid doubt, these are CGT assets ... Note 1: Examples of CGT assets are: ... options.

[16] (1996) 67 FCR 68; (1996) 137 ALR 193; (1996) 32 ATR 590; 96 ATC 4520.

[17] See above n 15 as to the *ITAA 1997* s 108-5 Note 1; see also Sorbello et al., above n 8, 7.

[18] [1923] HCA 36; (1923) 33 CLR 115, 120–21.

[19] [1957] HCA 90; (1958) 98 CLR 193.

[20] *Tax Laws Amendment (2010 Measures No. 4) Bill 2010*.

[21] Amendments to the scrip rules were introduced as part of the *Tax Laws Amendment (2010 Measures No. 4) Bill 2010* on 23 June 2010. See, generally, CCH Tax Editors, *Australian Federal Tax Reporter* (CCH Australia Ltd, Daily Online Update) [161-405, 161-406].

D. Putting TPD and Trauma on the Same Pedestal As Life Insurance

As discussed in Chapter Six, life insurance is given greater flexible CGT relief when compared to TPD and trauma. The legal separation of these three types of insurances is archaic and out-dated. The seminal *National Mutual* case was decided in 1959, prior to the sexual revolution.[22] Among other influencing factors, gender roles were less flexible at that time—the husband often went to work, while the wife, traditionally, attended to house duties. The death of a husband, who may be the sole family breadwinner, was catastrophic, leaving limited sources of income for the potentially unemployable wife. As the sole income provider, the husband might have seen it as prudent to insure against his own death.[23] It may have been perceived to be morally unfair to tax a payout meant to replace a widow's sole source of income. Such reasoning may underlie the general exemption from taxation of 'life insurance' provided by *ITAA 1997* section 118-300.[24]

The effect of the *National Mutual* case is that the proceeds of trauma (which did not exist in 1959) and TPD (which was not common at that time) are not given the same protection as is afforded to life insurance.[25] Trauma events such as cancer and heart attacks often lead to death, so much so that trauma insurance did not exist when *National Mutual* was decided.[26] However, since 1959, with the advances of medical science, a trauma event is no longer a precursor to death. For example, cancer may be successfully treated.[27] Hearts can be replaced or repaired.

Before 1959, persons who survived a disability often had little opportunity to be re-employed into the workforce. Today, a more tolerant, educated society, sympathetic to people with disabilities, provides greater workplace flexibility.[28] It may now be

[22] In 1959, the US banned *Lady Chatterley's Lover* by DH Lawrence for unnatural sexual content. The ban was overturned by the courts. The UK, in 1959, passed the *Obscene Publications Act*.
[23] There may have been no insurance considered for the wife. This may have been because, since her time was largely spent nurturing the home, husband, children and sometimes a more extended family, she did not bring in an income.
[24] However, the Information Memorandum is silent on this matter.
[25] *National Mutual* case (1959) 102 CLR 29.
[26] *National Mutual* case (1959) 102 CLR 29.
[27] Vincent T DeVita, Jr and Edward Chu, 'A History of Cancer Chemotherapy' (2008) *Cancer Research* 68 [8643].
[28] See Joann Sim, 'Improving Return-to-Work Strategies in the US Disability Programs, with Analysis of Program Practices in Germany and Sweden' (1999) 62 *Social Security Bulletin*, 41, 41–48.

possible for a person that has suffered such a disability to gain meaningful employment, potentially with the use of the insurance proceeds.[29]

Although the emotional toll has not changed, the financial burdens may now be different. The family's financial loss of a spouse through death may be partly recompensed by a payout from the superannuation fund.[30] The non-working spouse may find work following the loss by being better trained than are his or her parents. There is also an acceptance, availability and subsidising of child-minding services.[31] For the remaining family members, death may be less financially demanding when compared to a disability. With death, there is one less person in the family requiring maintenance. In contrast, suffering TPD and trauma events can result in expensive care requirements that may, in part thanks to medical advances, last decades. A commentator has put it thus:[32]

> The point I make here is that the *National Mutual* case was decided upon the life policy that was in existence pre 1959. No recognition has been given to the changes in life insurance contracts since that date that have arisen from the significant advances in modern medicine and the achievements of Dr Marius Barnard in designing trauma policies. The ATO has either failed or refused to give credence to Dr Barnard's significant achievement in designing trauma policies as prepayment of a death benefit to a life insured who but for the skill of the surgeon, would have died. The ATO has refused to consider this fact and maintained its view that trauma is a form of personal sickness and accident and therefore falls within the distinction that was made by Windeyer J in the *National Mutual* case between life insurance and personal sickness and accident insurance. The only justification for holding this view is a belief that to do

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[29] Ronald M Wrona, 'Disability and Return to Work Outcomes after Traumatic Brain Injury: Results from the Washington State Industrial Insurance Fund' (2010) 32 *Disability and Rehabilitation* 8, 650–655.

[30] An additional superannuation payment may be available as an anti-detriment payment. This is an amount paid by a superannuation fund on the member's death as compensation for the tax paid by the deceased member on contributions. The anti-detriment payment increases the amount of the lump sum benefit available on death. Under *ITAA 1997* s 295-485(a), the anti-detriment provisions only apply where a lump sum death benefit is paid in favour of the deceased member's spouse, former spouse and/or child of any age. This includes payments made to the trustees of the deceased member's estate, provided these people benefit.

[31] For example, the Child Care Benefit is a payment from the Commonwealth Government. It assists with the cost of childcare. Parents, foster parents and grandparents with a child in their care attending childcare services approved by, or registered with, the Commonwealth Government may be eligible. The Liberal Party's current policy, while in opposition, is to extend childcare support further to make it more accessible and affordable. See Tony Abbott, *Productivity Commission Review of Childcare* (Liberal Party, 27 March 2012) <http://www.liberal.org.au/Latest-News/2012/03/27/Productivity-Commission-Review-of-Childcare.aspx>.

[32] Martin de Haas, *Discussion of Australian Taxation Office Draft Discussion Paper in Relation to Buy-Sell (Business Succession Planning Agreements)* (unpublished, Western Australia, 2004) 4.

> otherwise will impact upon the revenue. In plain and simple English, the ATO wants to tax TPD and trauma policies where possible.

A good deal of the complexity in succession planning arises from the different tax treatment given to insurance policies that have essentially the same objectives. Based on the taxation benchmark of efficiency, there should be greater neutrality. The legislation should be amended to give TPD and trauma insurance the same taxation treatment as life insurance for the purposes of succession planning. The Full Court of South Australia, in *National Mutual Life Association v Commissioner of State Taxation*, noted that both the *Life Insurance Act 1995* and its predecessor, the *Life Insurance Act 1945*, linked life insurance policies to the happening of any 'contingency dependent on the termination or continuance of human life'.[33] The court held, in obiter dicta, that this 'distinguishes continuous disability policies' (such as TPD and trauma) from life insurance.[34] It is recommended that a legislative amendment should expand this to include continuous disability policies for succession planning.

E. Superannuation and 'Sole Purpose'

It is recommended that the 'sole purpose' test be amended to clearly state that a superannuation fund may invest in life, TPD and trauma insurance for funding a succession plan.[35] The use of such insurance for succession planning has become

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[33] *National Mutual Life Association v Commissioner of State Taxation* [2011] SASCFC 106. This case considered the meaning of 'life insurance' under the *Stamp Duties Act 1923* (SA), which prescribed lower rates of duty payable on premiums 'relating to life insurance' and higher rates on premiums 'relating to policies of any kind (other than life insurance policies)', such as TPD and trauma. The Full Court of the South Australian Supreme Court affirmed the decision at first instance, finding that the duty on the 'rider' policy to the life insurance policy is payable at the higher rate applicable to general insurance. As to this question, see also *Pass v Gerling Australia Insurance Company Pty Ltd* [2011] WASCA 93, where that case considered personal injury and whether the death of the deceased was an injury as defined in the insurance policy; and *Norwich Union Life Australia Limited v Commissioner of State Revenue* [2011] WASAT 149. Compare this to the Western Australia State Administrative Tribunal, which allowed a taxpayer's objection to an assessment of duty in relation to life, critical illness and income protection policies of insurance. 'Life policy' was defined in *Life Insurance Act 1945* (Cth) s 4(1) as:

> a policy insuring payment of money on death (not being death by accident or specified sickness only) or on the happening of any contingency dependent on the termination or continuance of human life (either with or without provision for a benefit under a continuous disability insurance contract), and includes an instrument evidencing a contract which is subject to payment of premiums for a term dependent on the termination or continuance of human life and an instrument securing the grant of an annuity for a term dependent upon human life.

[34] *National Mutual Life Associate and others v Commissioner of State Taxation* [2011] SASCFC 106 [31].

[35] This is as discussed in Chapter Six. Such investments are subject to the fund's trust deed and investment strategy permitting such investments.

'increasingly popular', even though there is doubt whether the holding of such investments complies with the sole purpose test.[36]

There is uncertainty from the regulators as to whether trauma, in itself, is a permitted investment for a superannuation fund. APRA has called it an 'unreasonable diversion', while the ATO believes it to be an acceptable 'benefit that will become part of the assets' of the fund.[37] The ATO considers that trauma can comply with the sole purpose test. To put the matter beyond doubt, legislation should be introduced to state clearly that trauma insurance is an acceptable investment for a superannuation fund when it is part of the funding of the succession plan.

As to the use of the insurances for succession planning purposes, the permitted 'core purpose' already includes funding a business owner into retirement. *SIS Act* section 62(1) provides for benefits 'on or after the member's retirement from any business, trade, profession, vocation, calling, occupation or employment in which the member was engaged'.[38] Life insurance caters for the event of 'death'.[39] Similarly, an 'ancillary purpose' includes providing employment termination insurance and 'disability superannuation benefit'.[40] It also includes salary continuance on a member's cessation of work because of health issues.[41] If the legislation were so reformed, then it would be permissible for a member, or the member's associate, to gain a personal 'benefit'

[36] Burgess, above n 3, 8.

[37] See APRA, Superannuation Circular No III.A.4 (Australian Prudential Regulation Authority, 1998) [47]. This can be compared with ATO, *Superannuation—Part IX Taxation of Superannuation Entities—Superannuation Fund Expenses—Trauma Policy*, ID 2002/371, 9 September 2007. However, the ID does not expressly consider the sole purpose test. Rather it considers the taxation deductibility of the premiums, posing the question: 'Is a deduction available to the trustee of the complying superannuation fund under *ITAA 1936* s 279(1) in respect of premiums paid by the fund for a trauma policy?'

[38] s 62(1)(a)(i).

[39] *Superannuation Industry (Supervision) Regulations 1994*, Regulation 6.01, sch 1, Item 102.

[40] As defined in *ITAA 1997* s 995-1(1), the:

> 'disability superannuation benefit' means a superannuation benefit if:
>
> (a) the benefit is paid to an individual because he or she suffers from ill-health (whether physical or mental); and
>
> (b) 2 legally qualified medical practitioners have certified that, because of the ill-health, it is unlikely that the individual can ever be gainfully employed in a capacity for which he or she is reasonably qualified because of education, experience or training.

[41] APRA, Superannuation Circular No. III.A.4 [7] states that 'the test is the legislative expression of the retirement income objective which is the key rationale for superannuation savings'.

outside the superannuation fund.[42] This is because the superannuation fund is providing insurance as the consideration required by the member to enter into a succession plan.[43]

F. Deductible Premiums and CGT Free Proceeds—Asprey's 'Special Treatment'[44]

As well as the taxation legislation as it relates to succession planning insurance being complex and uncertain in its application, it is also a cost disincentive. Under the 'replacement principle', if the item being insured is assessable as income, then the proceeds of the insurance that seek to replace the item are also assessable as income.[45] In such circumstances, the insurance premiums are also often deductible. However, as discussed in Chapter Five, this is not necessarily the case in succession planning. It is possible for the insurance premiums to be non-deductible and the proceeds subject to taxation.[46]

Inconsistencies and ambiguity in the law are demonstrated by the ATO's attempt to set out the relevant rules as to deductibility. For example, ATO Interpretive Decision ID 2004/661 deals with mortgage protection insurance used to protect non-business loans.[47] This would include a main residence mortgage.[48] According to ID 2004/661, such premiums are deductible and the proceeds are subject to income tax. Making payments on a taxpayer's main residence mortgage (the insurance's purpose) is, according to ID 2004/661, not of a 'capital, private or domestic nature'.[49] However, the interest paid on

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[42] A pt 8 'associate' of an individual includes a member's 'relative' (parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the member and his or her spouse: *SIS Act* s 10). See *SIS Act* s 70C.

[43] Para 17 of the ATO, *Self-Managed Superannuation Funds: Can a Trustee of a Self-Managed Superannuation Fund Purchase a Trauma Insurance Policy in Respect of a Member and Still Satisfy the Sole Purpose Test in Section 62 of the Superannuation Industry (Supervision) Act 1993?* SMSFD 2010/1 stated that:

> The sole purpose test in *SISA* s 62 requires exclusivity of purpose and therefore a trustee who maintains an SMSF for any other purpose contravenes s 62. Matters relevant to determining if the maintenance of an SMSF is in accordance with the sole purpose test include how fund assets are acquired and invested, how fund assets are employed, and what benefits are provided by the SMSF.

[44] Asprey Report, above n 5, ch 21.4.

[45] The decision in the *Carapark* case also demonstrates that the application of the replacement principle does not have to be direct, as, on the facts, a certain amount of separation between the taxpayer, a holding company and the employee of a subsidiary company existed.

[46] See Chapter Five.

[47] The type of insurance in ATO, *Income Tax—Deductions: Premium Incurred for the Disability Cover under a Mortgage Protection Policy*, ID 2004/661, 3 June 2004 was restricted to disability insurance, rather than life insurance.

[48] For the CGT main residence exemption, see *ITAA 1936* s 118-110. ATO ID 2004/661 related to a 'housing loan' that, while undefined in the ID, would include a main residence, such as a family home.

[49] ATO ID 2004/661, 2.

a main residence mortgage is not generally deductible.[50] As stated in ATO private binding ruling PR 94264, 'in determining whether an interest expense is deductible or not, we consider the purpose to which the borrowing is applied when the interest arises'.[51] As discussed in Chapter Four, inconsistencies arise from a comparison of Taxation Rulings IT 2678 and 2504. The above demonstrates that the regulator does not necessarily treat the purpose of the insurance as being decisive as to the deductibility of the insurance premiums.

To compound the problem, different rules apply depending on the type of insurance and the model adopted. As discussed in Chapter Six, life insurance and TPD are deductible expenses of a superannuation fund.[52] Such deductibility is generally not possible when the insurance is held externally to a superannuation fund. However, trauma insurance is not deductible in a superannuation fund. This fails the requirement of horizontal equity, as set out in the taxation benchmark of equity and fairness, which requires taxpayers in similar economic circumstances to be treated similarly.[53] This general exemption should apply to life, TPD and trauma insurance when it is part of the succession plan.

The removal of uncertainty and inconsistencies to succession planning is not enough; positive tax incentives are also required. Using the taxation benchmarks as a touchstone, a general exemption from CGT over and above the CGT relief afforded to life insurance under *ITAA 1997* section 118-300 should be considered. The Asprey Report argued for 'special treatment' of both life insurance and superannuation and stated that:[54]

> generally, life insurance and superannuation should not be dealt with in isolation to each other and ... the tax treatment of one should be consistent with the tax treatment of the other.

To remove the confusion, it is recommended that life insurance, TPD and trauma held for succession planning purposes both in and externally to superannuation receive favourable taxation treatment. This is to the extent that the premiums for life, TPD and

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[50] This is assuming that the residence is not used for income producing purposes and was not acquired or built for profit-making purposes.
[51] ATO, *Expenses—Investments—Travel*, PR 94264, 30 November 2009, 2.
[52] As set out in Chapter Six, TPD may only be partly deductible.
[53] See Chapter One.
[54] Asprey Report, above n 5, chs 21.2–3.

trauma are tax deductible, irrespective of which model is used to hold the insurance. This includes TPD and trauma premiums held in the superannuation fund. In addition, consideration should also be given to the insurance proceeds, as part of the succession plan, not being subject to any taxation impost. This is based on the above justification of the exception of neutrality set out in the Asprey Report and the importance of succession planning in protecting the ongoing viability of the small business.

G. Outgoing Owner's Cost Base

Under both the self-ownership and superannuation models, the remaining owners provide no money to acquire the outgoing owner's business interest. However, in the cross-ownership model, the insurance is paid to the remaining owners, who then use that money to acquire the outgoing owner's business interest. As demonstrated in Chapter Six, the remaining owners are unlikely to gain the first element of the cost base when they acquire the business interest. When the time comes for the remaining owners to dispose of the business interest that they acquired from the outgoing owner, they will be subject to CGT without the benefit of the first element of the cost base. This offends neutrality. Rather than seek to negotiate the market value substitution exemption under section 112-20 and deal with the tortuous 'not deal at arm's length' requirement, it is recommended that the insurance that is received in a succession plan constitute consideration for the first element of the section 110-25 cost base. This is irrespective of how the insurance is owned and of the model used.

If the reforms were implemented, then, under the cross-ownership model, the remaining owners would claim a taxation deduction for the insurance premiums, receive the proceeds tax-free and then use the proceeds to establish the first element of the cost base. This may be perceived to be 'double dipping'.[55] However, the outgoing owners have taken the risk in purchasing insurance that may never derive any proceeds. Further, irrespective of whether the premiums are tax deductible, the outgoing owners have expended money to pay the premiums. Given the special nature of insurance and the value of protecting the small business using succession planning, it is submitted that the

[55] The term 'double dipping' is adapted from *Robe River Mining Co. Pty. Ltd. v. FCT* (1988) 19 FCR 294, (1988) 83 ALR 369, (1988) 19 ATR 1648, 88 ATC 4701, 4712.

taxation relief is warranted and justifiable. There are other examples in which such treatment has been so sanctioned by legislation.[56]

H. Conclusion

Taxation policymakers and regulators are interested in understanding business. In the UK, Revenue and Customs identified a need for tax inspectors to understand 'business drivers'.[57] The Australian Federal Government provided similar advice:[58]

> Nobody likes to think about it, but it is inevitable that one day you will leave your business. Whether you decide to sell up, retire or have to get out of business due to health reasons, it is important that you plan for that day. A succession, or exit, plan outlines who will take over your business when you leave. A good succession plan enables a smooth transition with less likelihood of disruption to operations. By planning your exit well in advance, you can maximise the value of your business and enable it to meet future needs.

Thus, the Australian Government recognises that succession planning is an integral, if not essential, part of running a successful small business. However, the activities of the ATO and the ambiguous legislation are not in accord with the Government's recommendation for business to undertake succession planning. There is dissonance between the Government's policy and the implementation of the ambiguous legislation under the Government's taxation regulator—the ATO.

The result of the Australian taxation system is that there is no consensus on the structuring of a succession plan and the insurance model. All structures have fundamental defects, risks, complexity and ambiguity. There exists uncertainty.

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[56] As discussed in Chapter Five, where a person reaches a certain age, it is possible for no taxation to be paid on superannuation contributions, no income tax to be payable on income earned on that contribution and then for the contribution to be paid tax-free, by way of an annuity, to the member.

[57] UK Inland Revenue 'Review of Links with Business' (2001) <inlandrevenue.gov.uk/pbr200l/businesslinks.pdf>. Similarly, the Irish Revenue stated that its goals are to be 'rooted in the reality of our business environment'. Irish Revenue, 'Statement of Strategy 2003–2005' (2003) <www.revenue.ie/pdf/sos03-05.pdf>. The Irish Revenue comes under the ambit of the Government's Department of Finance. It is responsible for tax administration and has some input in taxation policy. Its UK counterpart is Her Majesty's Revenue and Customs (formerly the Inland Revenue) and its US counterpart is the Internal Revenue Service.

[58] 'Succession Planning', *business.gov.au* (2012) <http://www.Business.gov.au/Business+Entry+Point/How-to+guides/Exiting+a+business/Succession+planning.htm>.

Indeterminate and uncertain tax laws give rise to exploitation of loopholes by taxpayers, such as cancelling and entering into fresh insurance policies to avoid CGT. Each insurance model has advantages and disadvantages, with no clear or 'tax fair' choice.

Some small businesses may lack the resources and be deterred from establishing a succession plan because of the taxation complexity and incoherence. This is unfortunate, as these owners may be the most vulnerable.

The research confirms that small business is important to the Australian economy and that the death or disability of a principal can risk the existence of an otherwise viable business. The suggested taxation reform helps support the viable small business after a principal's death or disability.

Implementation of the above reforms, while not solving all taxation issues in succession planning, would alleviate the bulk of the unfairness and create greater certainty, in line with the taxation benchmarks. The results may be that more owners will enter into insurance-funded succession plans. Apart from rectifying uncertainty and ambiguity in the legislation, some of the suggested reforms may reduce revenue. Revenue is important to the Australian Government and the ATO. However, the sustaining of taxpaying small businesses when a principal dies or is disabled may well offset the taxation revenue lost. An increase in owners entering into succession plans may expand the taxation base, so that the reforms do not lead to an overall reduction of the taxation revenue.

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