



Managing business succession

Tony Negline examines what to do when someone dies unexpectedly, goes to jail or suffers serious sickness or injury

A key objective of business succession in many small or medium businesses involves seeking to ensure that a business survives after a significant event such as death, permanent disablement, temporary disablement, imprisonment or even bankruptcy. Typically a lot of the focus is on working out what happens upon death, even though statistically disability or medical traumas are more likely to occur.

Business succession involves establishing a written agreement between the shareholders, partners or principals, which should discuss two aspects - disposal and funding.

Paul Hockridge, a Deloitte tax partner in Melbourne, believes that all business succession plans should be tested against three criteria - certainty, simplicity and flexibility. However, he believes it is extremely difficult to achieve a high degree of all three objectives at the same time.

He says it's often better to deal with the critical issues as soon as possible and then agree on a timetable to consider any other important issues.

Some of the information that has to be gathered when designing a buy-sell agreement might include the following:

- Asset ownership and net market value.
- Structure - trust deeds, company constitutions, shareholder agreements, options contracts, et cetera.
- People - who works in the business and what are their roles? What expectations do they have and what promises have been made?
- Goals - what is to be achieved, by whom and by when?
- Financing - what funding is required to make a business plan happen?
- Due diligence - what is the business really worth?
- Estate planning - does the business suc-



Tony Negline

cession plan fit in with the estate plan?

Unsurprisingly, one key aspect, which must be considered in all business succession plans, is tax. This might include income tax, capital gains tax, fringe benefits tax, GST, stamp duty, et cetera.

DIFFERENT TYPES OF BUY-SELL AGREEMENTS

How will a business be purchased? In many cases this occurs via various different types of life insurance contracts, because the putative purchaser will not be able to self-fund or raise the funds to purchase the business. Over the years the following approaches have been used:

- Cross insurance - under this model each proprietor has a fractional interest in the life insurance policies on the lives of all the other owners. It is my understanding that many years ago these arrangements were quite popular but are much less so now principally because of the adverse capital gains tax issues that typically

arise with this type of structure.

- Share/unit buy-backs - with this arrangement the business itself might take out the insurance and then use it to fund a reduction in shares or units on issue. This method is often very tax inefficient for the surviving owners (they own all the equity in the business but haven't received any cost base increase in their purchase price for CGT purposes).

- Trust model - this usually involves the creation of a special purpose trust with its trustee owning the insurance policies. If an insurance payout is received then the trustee will receive the proceeds and apply the funds according to the terms of trust.

In May 2000 the Australian Taxation Office (ATO) expressed some concerns about this arrangement, so anyone wanting this type of structure should consider getting a Private Binding Ruling from the ATO.

One advantage with this approach is that one larger policy can be purchased and this might generate some important and significant cost savings.

- Self-funding insurance - as might seem obvious from the name of this arrangement, each proprietor takes out insurance on their own life. Any claim on a life insurance policy is paid to the individual proprietor or their estate.

Under these arrangements the existing proprietor is taken to have disposed of their equity to the remaining proprietors at market value. The remaining proprietors are deemed to have acquired the equity at an equivalent value. If the business equity is owned by a discretionary trust then some advisers think that in order to avoid an accusation of a breach of trust, then the trustee needs to have the power to enter into a self-funding insurance buy-sell arrangement.



What happens if self-funding insurance is used? This means that life insurance policies have not been used and it is up to the surviving proprietors to pay the market value for the departing proprietor's equity. The agreement should provide how to determine the value to be paid. Normally the actual amount to be paid is reduced by one dollar for every dollar of insurance proceeds received.

What happens if a proprietor cannot obtain life insurance? Or similarly, what happens if the required life insurance is too expensive? Hockridge believes that you may still be better to proceed with the buy-sell agreement because solving some of a problem is better than solving none of it.

In the past many disposal arrangements were mandatory - that is, if X occurs then Y must happen - which forces the disposal and subsequent purchase. The problem with many of these arrangements is that they give rise to capital gains tax at the date of contract, not the date of settlement.

An alternative is to use a "put and call option", which provide flexibility and security. For example, if event X occurs then Y will have the "right" to purchase Z's interest in the business. The right to purchase is the "call" option. The "put" option will occur if the agreement gives Z the option to sell the business to Y if event X occurs.

Most arrangements will say that the transactions must be finalised within a certain period of time.

Common issues include who should own the insurance contract and who should be the nominated beneficiary. The nominated beneficiary can be anyone, including the policy owner.

One key aspect which must be agreed upon is who will be the payer of the insurance policy premiums. Normally these premiums are not tax deductible. As is well known, the cost of

insurance varies greatly depending on people's age, occupation and health. With most buy-sell arrangements the insurance premiums are spread equally between the parties.

THE END OF THE BEGINNING

Even though in most cases a business succession plan will be written down and signed by relevant parties, it is important to realise that this is the "end of the beginning". Business succession plans need to be structured to enable them to be changed on a timely basis.

GST AND STAMP DUTY ISSUES

In Hockridge's view, careful advice needs to be taken in relation to the transfer of equity or interests in assets under buy-sell agreements as well as insurance premiums and proceeds, because of the potential GST implications.

Stamp duty can also apply in some jurisdictions and some care needs to be taken.

CAPITAL GAINS TAX

The 50 per cent shareholder discount is not available if the asset is disposed of because of an agreement entered into within 12 months of acquiring the asset.

However, the ATO has advised that this restriction does not apply to buy-sell agreements.

If you have to pay CGT on insurance contracts (because you weren't the original beneficial owner or because you own a trauma insurance policy and you weren't the injured party or relative) then you might like to claim the 50 per cent discount. The ATO has advised that in most cases this discount will not be available.

BUY-SELL AGREEMENTS

In the past 15 years it has become common for insurance contracts to be owned by a super fund trustee to provide for business succession.

The advantage here is that the insurance

premiums are often tax deductible.

For the moment let's assume the death of a business owner. Under this scenario the super fund will pay (under some sort of binding nomination) a beneficiary the proceeds of the death insurance policy and the beneficiary will have an obligation under the business succession agreement to hand over equity in the business.

A key question will be whether or not such arrangements satisfy the super laws. Can super be used to, in effect, sell a business?

There are many views in the super industry. Some argue yes without hesitation. Others believe no in all circumstances. Others say possibly, depending on the circumstances.

Hockridge believes that a super fund should be used with great caution.

GUARANTEES AND FORGIVING LOANS

Existing proprietors have often made loans to their business and/or have loaned money from their business. They may also have provided guarantees or indemnities.

To ensure a clean exit for the departing proprietor the debtor might insure the amount of debts. This is done to avoid commercial debt forgiveness, which can cause a reduction in tax losses, capital losses, the written down value of depreciated assets and the cost base of CGT assets.

Under typical buy-sell agreements the remaining proprietors often get the exiting owner or their estate released from a guarantee.

The payment of a guarantee is normally considered to be capital and hence not tax deductible. In most cases it will also not generate a capital loss. ■

Tony Negline is general manager, corporate strategy at SUPERCentral - www.supercentral.com.au. He is also the author of "A How to Book of Self Managed Superannuation Funds". See www.atcbiz.com.au/smsfstore.php