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Business Succession: The Latest Trends

WHITEPAPER

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The latest trends

Introduction

Mark Twain once said about the weather: "Everyone talks about it but no-one does anything about it". The same may be said for Business Succession.

It has a tendency to be dismissed as forming a minor role in related issues such as asset protection, business structuring, estate planning and business contracts. The reality is that business succession lies at the core of these concepts.

This pervading ambivalence is, to my mind, an indication that very few people in the business community really understand what business succession is all about. And I include many business lawyers in that statement (unfortunately).

Payments to the exiting business owner and to who else?

The Rolls Royce of business succession is the *Insurance trust deed*. It allows payments to be made by the departing business owner to third parties. Many business owners and their legal representatives alike are alert to the need to be paid out the entitlement as a *pro rata* portion of the value of the business.

However, who can deny that over the years, a business owner (e.g. shareholder, owner of units in a unit trust or common law business partner) will have accrued a whole lot of commercial relationships between that business owner and the trading entity on the one hand and also between that business owner and other associated entities on the other?

Loans are made by the business owner to the trading entity. Loans are made by the trading entity to the business owner. Are any debts of the trading entity secured by someone related to the exiting business owner? How will they be paid out?

The business owner typically gives guarantees – and then they can forget to have them paid out when they leave causing mischief down the track.

When an exit occurs, assets (shares, units etc) are sold and obligations can be incurred – for example, accounting fees, legal fees and stamp duty are just some of the obligations that an exit might trigger. Others include a potential tax liability relating to the dividends received on settlement, or the capital gain on the sale of the shares on the exit.

What about exiting related entities – service entities, suppliers etc. Dealing with them can be made more difficult where the interest in those other entities is not held by the exiting business director/shareholder, but by his family trust for example.

Sometimes the exit can include the departing director taking their company car with them – who is going to pay it out, if it is still subject to finance in the company's name?

What about the capital loss to goodwill of the business if a key shareholder were to die or become permanently disabled? Who is going to pay for that?

The questions vary depending on whether you are the exiting shareholder or the continuing shareholder. They vary depending on whether the business is to be retained, sold or liquidated.

Life insurance can be used

Many people are aware of the benefits of having insurance policies over the life of shareholders to fund the capital costs of buying their interest in the business once a trigger event occurs. For various reasons, the life insurance must be held in the name of the person. Cross insurance is not appropriate for various reasons beyond the scope of this short presentation.

Once the problem of funding is identified, then the next issue is how to deal with it. Here we have to contend with section 118-37 of the ITAA 97. That is to the effect that the proceeds of any TPD or trauma insurance policy must be received by the person suffering the TPD or trauma or their relatives. If not, then CGT will apply to the proceeds. Who wants to pay for a grossed up payment to take CGT into account, with the additional premiums which will go with it? And the payments may go on for years before a claim is made. A claim may never be made.

The insurance trust deed provides for the one entity – an insurance trust – to hold the policies of each director/shareholder in trust for each nominated director/ shareholder. The beneficiary is "absolutely entitled" to the proceeds and so there is no taxable event when the proceeds are paid to the insurance trust trustee, as it is holding the proceeds for the benefit of the beneficiary director/shareholder.

We have obtained a tax ruling to the effect that our documents can provide for the beneficiary director/shareholder to direct the trustee to pay nominated third parties pre-determined amounts from the insurance proceeds. And as the other directors/shareholders are also the directors/shareholders of the corporate trustee of the insurance trust, these pre-determined directions are assured of being adhered to.

The twelve trigger events

Left to their own imagination, clients typically think of death and voluntary departure as being the only events that might warrant a departure from the business entity. There are at least another ten events that should be included in an up-to-the-mark business succession agreement.

The 12 events are:

1. death;
2. total and permanent disability;
3. trauma / illness event;
4. commission of an act of bankruptcy or the appointment of a liquidator or administrator to the director's related shareholder;
5. becoming convicted of a criminal offence other than one related to driving a motor vehicle, the penalty in respect of which includes a gaol sentence of not less than six months;
6. committing an act or omission or becoming involved in any situation or occurrence which brings them or the company into public disrepute or scandal;
7. notifying the parties that they wish to dispose of their equity;
8. Where the party is a director of the business entity, either (i) failing to comply with their obligations under the Corporations Act after being given reasonable notice to do so, or (ii) resigning as a director;
9. the party's transfer or attempted transfer of the equity in breach of the business succession (a.k.a. buy-sell) agreement;
10. Where the party is an employee, failing to comply with their obligations under the employment contract after being given reasonable notice to do so;
11. Where the party is an employee, that party ceasing to be an employee for any reason;
12. The party breaching any of the terms of the buy-sell agreement and not rectifying the breach after being given reasonable notice to do so.

Popular funding options beyond insurance

1. Insurance proceeds are payable but they fall short of the purchase price ("**the Shortfall**"). If the Shortfall arises as a result of the party failing to use their best endeavours to maintain the level of insurance cover required, then the purchase price is reduced by the Shortfall.

2. If no proceeds are payable as a result of the party failing to use his best endeavours to maintain the level of insurance cover required, then the purchase price is zero.

3. Where:

(i) all agree that the premiums for a trauma or total and permanent disability policy in respect of a particular party are too expensive to enable the proceeds to cover the purchase price; and

(ii) the policy in respect of the trauma or total and permanent disability for that party is taken out for an amount of cover less than the purchase price; and

(iii) the subsequent proceeds ("**the Reduced Proceeds"**) upon a claim being made are less than the purchase price; then

(A) the Reduced Proceeds are applied towards the purchase price; and

(B) the difference between the Reduced Proceeds and the purchase price is paid in equal monthly instalments over a period of three years;

(C) interest at …% is payable .

4. If a trauma event occurs and proceeds are paid but no option is exercised and within two years a second trauma event occurs but no proceeds are paid either as a result of its proximity to the occurrence of the first trauma event or for any other reason, and an option is exercised as a result of the second trauma event, then the purchase price shall be reduced by the amount of the proceeds payable as a result of the occurrence of the first trauma event.

5. If a TPD or trauma event occurs and proceeds are received but no option is exercised and the applicable person dies within 5 years and no insurance proceeds are paid or payable in relation to the death for any reason, then the purchase price in relation to the death shall be reduced by the amount of the proceeds received in respect of the TPD or trauma.

6. If a trauma event occurs and proceeds are payable but no option is exercised and the Business is sold to a third party within 2 years after the proceeds are received by the insured, then those proceeds are to be notionally added to the net sale proceeds (the total being "**the notional sale price"**) and then set–off against the payment that would be payable to the insured upon the settlement of the sale assuming that the amount to be split between the parties on the settlement of the sale was the notional sale price.

7. Where an option is exercised in relation to the occurrence of a trigger event which is uninsurable, then 20% of the purchase price is payable upon completion, and a further 20% is payable on each of the next four anniversaries of the completion date. No interest is payable in such circumstances. Security should be considered. A general security interest in the assets of the business might be warranted or else a specific security agreement by which the continuing parties charge their own assets.

8. Payment of the purchase price is made over time at the same time and in the same amount as dividends which are payable to the continuing parties. Security should be considered as above.

9. Care needs to be given in relation to "8" above, so that any loan amounts owing by the business to the continuing shareholders are taken into account when calculating the

repayments. Otherwise, the business may never declare dividends, but the continuing shareholders will still benefit by having their loan balances reduced.

Complications where there are related enterprises

You can have just an individual director/shareholder involved, or an individual director with his family discretionary trust as the corresponding shareholder.

They can have their spouse as director/shareholder of any one or more related entities. Other related entities could include a self-managed super fund which is full or part owner of the business premises. Part ownership (as tenants in common) is a *single acquirable asset* under section 67A(1)(a) of the SISA. The super fund will need a corporate trustee if it does not already have one.

Take another example where Asset *Co* owns the assets of the enterprise and leases or licences the use of the assets (like intellectual property) to the trading company - "*Trading Co*." An exit from one mandates an exit from the other. *Employee Co* might be the entity which employs all the staff. An exit from that company will also be required.

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