

Business Succession Planning

Introducing Business Succession Planning

Congratulations on taking the first step to protect your interest in your co-owned business. Business Succession Planning is essential for protecting your interest in a co-owned business and is an integral part of every business co-owner's individual Estate Planning.

"**Business Succession Planning**" means:

- Planning for the sale or purchase of a co-owners' interest in a business in the event of their death, permanent disablement, serious illness/trauma or other circumstances and funding for that sale/purchase, (See Buy/Sell Option Agreements below), and
- Planning for the preservation and growth of co-owners' equity in a business by the implementation of agreements between co-owners governing the management and decision making of the business and ability to dispose of an interest/share (See Shareholders' Agreements below).

Problems associated with a business co-owner suffering an untimely death or injury, as well as disputes between co-owners, both of which often lead to the financial ruin of a business, can be managed or avoided by the consideration and implementation of suitable Business Succession Planning Agreements and related insurances. The avoidance of these problems will ultimately protect you and your family and preserve your Estate assets.

Where to Start?

If you are a co-owner of a business you should at the very least consider the benefits for you and your family of having proper Business Succession Planning Agreements in place. The

information below will assist, however, please feel free to call and speak to one of our Commercial Lawyers should you have any questions. (02 4943 3905).

What is a Buy/Sell Option Agreement?

A Buy/Sell Option Agreement is an agreement between co -owners of a business granting each other options to buy or sell their respective interests upon the occurrence of specified Option Events. The Option Events are typically:

- the Death of a co-owner;
- the Permanent Disablement of a co-owner;
- Serious Illness/Trauma in connection with a co-owner such that they are no longer able to continue to work in the business; and
- the Retirement or Expulsion of a co-owner (although these circumstances would ordinarily be dealt with in a Shareholders' Agreement/Partnership Agreement if one existed for the business).

Enforceable Buy/Sell Option Agreements overcome disputes in relation to the buy out of a co-owner's interest in a business including in relation to:

- rights to buy or sell,
- valuations of interests,
- timing of payments, and
- funding arrangements.

Funding Agreements are frequently entered into in connection Buy/Sell Option Agreements and provide for the funding of the price for a co-owner's share in the event that

an option to buy or sell is exercised. Funding is usually provided by:

- the maintenance of personal insurances in respect of the co-owners,
- agreements in the form of vendor finance, or
- a combination of each.

Why do I need a Buy/Sell Option Agreement?

In the absence of a Buy/Sell Option Agreement disputes between co-owners or their executors/beneficiaries following the occurrence of an Option Event are common. These disputes typically relate to:

- Who may purchase the co-owner's interest;
- Whether the affected co-owner or their Executor can insist that the continuing co-owner(s) purchase the relevant interest;
- Whether a deceased co-owner's spouse/children (or other beneficiary) are entitled to keep the interest and participate in the running of business;
- The price to be paid for the co-owner's interest in the business;
- How the price is to be determined in the absence of an agreement, and
- When and how the price is to be paid.

What if...

Imagine the implications for yourself and/or your family in the following circumstances which may arise in the absence of a Buy/Sell Option Agreement:

You have died unexpectedly;

However, your co-owners are unwilling or unable to pay your Estate the value of your share in the business. Your Executor/Spouse may be forced to participate in the running of the business until a purchaser can be found. It is likely that your Executor/Spouse will end up accepting an amount significantly less than the true value of your interest in the business in order to realize some capital for the same.

You have suffered a permanent disability or serious illness/trauma;

Again, your co-owners may be unwilling or unable to buy out your interest in the business. You will likely end up not getting anything, or something significantly less than the true value, for your share in the business. If you were relying on the value of your interest in the business to pay off a Mortgage you may now suffer financial hardship and/or be unable to live as comfortably as you would have liked, especially in view of your unfortunate circumstances.

One of your co-owners has suffered a permanent disability or serious illness/trauma or died unexpectedly;

You feel sorry for your co-owner or deceased co-owner's family but either can not afford to buy out their share of the business or do not consider that such a purchase is a good commercial decision for you and your family at the time. You object to the eventual proposed purchaser of the deceased co-owner's share of the business and/or can not agree on management and/or operational decisions. You eventually end up in dispute with the new co-owner. Your equity in the business diminishes or the business fails as a result of the internal dispute.

Alternatively, your disabled co-owner or deceased co-owner's family want to maintain an interest in the business and actively participate in management decisions and operations. You would prefer to buy out the interest in the business but they do not want to sell or demand an unreasonable price. You do not agree with their suggestions for the management operation of the business and end up in dispute. Your equity in the business diminishes or the business fails as a result of the internal dispute.

What is a Shareholders' Agreement

A Shareholders' Agreement (similar to a Partnership Agreement) is an Agreement between two (2) or more co-owners of a business setting out their agreements with respect to the management and control of the business and roles and responsibilities of each of the co-owners. Shareholders'

Agreements also dictate the rights and obligations of co-owners in the event of a

dispute or proposed sale of their interest in the business.

Among other things, Shareholders' Agreements regulate the following:

- the Purpose of the Company;
- the Roles and Responsibilities of Shareholders;
- the Appointment and Removal of Directors;
- Remuneration and Indemnity of Directors;
- Board Meetings, Voting and Decision Making on behalf of the Company;
- Management of the Company;
- the preparation and review of Budgets, Business Plans and Financial Information;
- Access to Company Information;
- Funding of the Company, Loans and Guarantees;
- the Issue and Disposal of Shares;
- Drag and Tag Along rights of Shareholders;
- Rights to Acquire Shares of retiring or terminated Shareholders and methods for valuing Shares;
- Dispute Resolution procedures;
- Restrictions on Competition by existing and former Shareholders; and
- Confidentiality of Information.

Why do I need a Shareholders' Agreement (Partnership Agreement)?

Anyone who is a co-owner in a business should have a Shareholders' Agreement (if the business is carried on by a company) or a Partnership Agreement. These Agreements minimize the likelihood of a dispute by ensuring that the co-owners have considered the objects of the business and their individual roles, rights and responsibilities. Disputes between co-owners who have not entered into a shareholders' Agreement are more common as there has generally not been any prior consideration or discussion of the co-owners' respective commitment to the business or restrictions on dealing with their interest in the business.

Most people that enter into business together are confident that they can maintain an amicable relationship when running the business, however, where the relationship can not be maintained, co-owners who have not

made a Shareholders' Agreement stand to lose considerably more. Disputes in relation to the following are more likely to have a crippling effect on you and/or your business in the absence of a Shareholders' Agreement:

- The direction and growth of the business;
- The appointment or removal of a person as a Director;
- The level and minimum duration of each co-owners' commitment of time and financial resources;
- The denial of a co-owner to relevant information and/or exclusion from decision making;
- The payment of dividends vs the retaining of profits for future growth;
- The issue of new shares to new investors/co-owners;
- The sale of a Shareholder's Shares to an unsuitable third party or without first offering the Shares to the other Shareholders;
- The sabotage by a co-owner of a proposed take-over or merger;
- The right to buy back the Shares of a co-owner who is no longer fulfilling their contribution to the business as originally contemplated;
- The valuation of the Shares of an outgoing co-owner;
- The carrying on of a similar business by a former Shareholder in competition with the business.

The time and cost alone of dealing with any of the above disputes can lead to the financial ruin of a business and total loss of value of a co-owner's equity.

Funding the Purchase Price under a Business Succession Plan

When a co-owner exercises an option to buy or sell their equity in the business a liability will arise for the continuing co-owner(s) to pay an amount ("**purchase price**") for the value of the outgoing co-owner's equity in the business. Most Business Succession Plans involve the maintenance of personal insurance policies in respect of each co-owner so that a lump sum will be received under the policy to pay the purchase price when an option is exercised.

In some cases, funding can also occur under a Vendor Finance Agreement or a combination of vendor financing and personal insurances.

Structuring Policy Ownership for Business Succession Planning

The following options exist with respect to the structuring of ownership for personal insurances policies under a Business Succession Plan:

- Self Ownership;
- Cross Ownership; and
- Trust Ownership.

In more recent times Super Fund Ownership has also emerged as an option for Policy Ownership due to the argument for tax deductibility of premiums. However, significant uncertainty remains in connection with the legitimacy and tax-effectiveness of Super Fund Ownership, in particular, in relation to the strategy complying with the 'Sole Purpose Test'. As a result, Investor Legal Network, does not generally recommend Super Fund Ownership for structuring Business Succession Planning insurances.

Capital Gains Tax ('CGT') & Business Succession Planning

Generally, CGT is payable on the proceeds of a claim on an insurance policy unless an exemption is available. Traditionally, the choice of ownership of personal insurance policies for business succession planning has been determined based on the availability of an exemption for Capital Gains Tax ('CGT') on the insurance proceeds.

In Australia, the CGT laws differentiate between tax payable for Death Benefits and tax payable for Non-Death Benefits (such as Total and Permanent Disablement, Trauma and Terminal Illness Benefits).

CGT & Insurance Proceeds

Death Benefits

Pursuant to section 118-300 of the *Income Tax Assessment Act 1997*, insurance proceeds paid on the death of a person ('**Death Benefits**') will be exempt from CGT if the recipient of the proceeds is the person or the entity who was the "*original beneficial owner*" of the policy. Therefore, a Death Benefit will

potentially be exempt from CGT whether the policy was self owned, cross owned or owned by a trust. CGT will only be payable on a Death Benefit where the recipient is not the original beneficial owner of the policy, for example, where:

- The benefit of the policy is purchased by a third party;
- The legal owner of the policy makes a declaration that it thereafter holds the benefit of the policy on trust for a third party, or
- A Court finds that a third party had an equitable or beneficial interest in the benefit of the policy. (See below, why buy/sell arrangements should always be documented in a formal agreement).

Non-Death Benefits

Non-Death Benefits (such as Total and Permanent Disablement and Trauma Benefits) received under an insurance policy are not specifically dealt with by the CGT legislation. The exemption for these proceeds is more limited and does not depend on the notion of "*original beneficial owner*". Section 118-37 of the *Income Tax Assessment Act 1997* provides an exemption for "*compensation or damages you receive for any wrong, injury or illness you or your relative suffers personally*".

The exemption is only available if the person who receives the proceeds was the injured person or a relative of that person. The ATO's current view is that Non-Death Benefits will only be exempt from CGT for Self Ownership and Trust Ownership.

Therefore, the Cross Ownership of an insurance policy for total and permanent disablement and/or trauma will result in a liability for CGT in the event of a claim.

Terminal Illness Benefits

On 28 March 2007 the ATO issued Tax Determination 2007/4 in which it expressed the view that a benefit received under an insurance policy as a result of a terminal illness is to be treated as if the benefit was a Death Benefit. The result of the Tax Determination is that the proceeds of insurance as a result of a Terminal Illness Benefit will be exempt from CGT regardless of the nature of the legal ownership of the policy, provided that the recipient of the proceeds is the "*original beneficial owner*".

Self Ownership of Personal Insurance

Self Ownership simply refers to the ownership of the insurance policies by the relevant Life Insured. Traditionally, insurance policies in connection with Business Succession Planning Agreements have been Self Owned as a result of:

- there being certainty that the insurance proceeds would be exempt from CGT; and
- an unfamiliarity with the concept of Trust Ownership by advisors of business owners.

Self Ownership is appropriate when a co-owner's equity in a business is owned by them personally and not be a related company or family trust or spouse. When a policy is self owned the insurance proceeds are paid to the Life Insured or their Estate and credit is given for those monies to the purchasers of the equity of the business under the related Buy/Sell Option Agreement.

The obvious benefit of Self Ownership, especially where the equity in the business is owned by the Life Insured, is that both Death and Non-Death Benefits are exempt from CGT. The only real limitation of Self Ownership, where the equity in the business is owned personally by the Life Insured, is that the continuing owners ('*purchasers*') are unable to control the application of the insurance proceeds, where necessary, to:

- the extinguishing of any loan secured over the outgoing owner's equity in the business; or
- the use of the funds for debt reduction purposes of the business, where the debt reduction was contemplated in the business succession planning arrangements.

Cross Ownership of Insurance

Cross Ownership refers to the ownership of an insurance policy in respect of the Life Insured by all owners of the business other than the Life Insured. *Cross Ownership* also includes circumstances where the business itself may own a policy in respect of the Life Insured, for example where there is an agreement to apply the proceeds towards debt reduction or to fund the buyback of shares in the company.

Cross Ownership is sometimes preferred to ensure that the insurance proceeds are received by the continuing owners ('*purchasers*') who can then control the application of those monies, which would usually include:

- the payment of the purchase price for the outgoing owner's interest in the business; and
- if part of the Business Succession Plan, payment of monies to reduce debt of the business.

Whilst a CGT exemption is available for Death Benefits, *Cross Ownership* will result in a CGT liability in the case of Non-Death Benefits (such as Total and Permanent Disablement and/or Trauma Benefits) paid following a claim. As such, unless the amount insured for *Non-Death Benefit* cover is increased to anticipate the CGT liability, *Cross Ownership* will result in an avoidable CGT liability. As such, the preferred methods of ownership of all buy/sell insurance are Self Ownership or Trust Ownership.

Trust Ownership of Insurance

Trust Ownership means that a Trustee is the legal owner of the policy on behalf of the Life Insured. As the Life Insured will still be the "*beneficial owner*" of the policy, Death Benefits paid under a trust owned policy will still be exempt from CGT where the Trustee is bound to pay the *Death Benefit* to or at the direction of the Life Insured. Similarly, where the Trustee receives a Non-Death Benefit on behalf of the Life Insured in circumstances where it is bound to pay that benefit to or at the direction of the Life Insured, *Trust Ownership* will preserve the CGT exemption for that *Non-Death Benefit*.

To achieve these exemptions, and the broader intentions of the business succession planning arrangements, the Trustee and all relevant parties must enter into an agreement ("Trust Owned Insurance Agreement") setting out, among other things:

- the parties' respective obligations in relation to the maintenance of policies on behalf of the Life Insureds (the '*beneficial owners*'),
- those beneficial owners pre-determined directions to the Trustee in connection

with the payment of the insurance proceeds.

These pre-agreed directions ensure that the true *Related Entity Owners* receive the sale proceeds for their equity in the business and that any intended part be paid to reduce debt of the business. As such a Trust Owned Insurance Agreement can facilitate the maintenance of a single policy in respect of a Life Insured covering amounts required to:

- Perform the continuing owners' obligations under a Buy/Sell Option Agreement, namely to pay the market value or purchase price for the outgoing owner's equity;
- Reduce business debt proportionate to the outgoing owner's equity in the business to ensure the release of any personal guarantees of the corresponding Life Insured and their Estate; and
- Cover the personal insurance needs relevant to the individual Life Insured, for example for the purpose of paying out a mortgage over the Life Insured's home.

Trust Ownership is, therefore, recommended whenever the real owners of the equity in the business is a related entity of a Life Insured (such as a Company or Family Trust).

Risks of not making a legal Buy/Sell Option Agreement

Too often business owners use Self Ownership or Cross Ownership structures to hold policies of insurance in respect of each other without formalising their intentions pursuant to a written Buy/Sell Option Agreement. The maintenance of insurance policies overcomes a funding problem only, however, does not address the usual problems that can arise in the absence of a written agreement.

The following are some of the implications of not formalising a Buy/Sell Option Agreement in relation to a Business Succession Planning Strategy:

- Disputes may arise in relation to the enforceability and/or terms of the agreement, including:
 - the method of calculating the price for an outgoing owner's equity,

- the obligation to accept the insured amount in lieu of the market value, or
- when and how the price is to be paid,
- If a dispute arises and Self Ownership has been the preferred strategy for structuring ownership, the dispute will be occurring at a time when the Life Insured (or their Estate) has or will receive the insurance proceeds directly without any ability for the continuing owners to control the application of those proceeds, and
- Finally, in the absence of an agreement in relation to the existence of terms of a Buy/Sell Option Agreement, litigation may result in the Court making an order determining that the continuing owners have a beneficial interest in the policy pursuant to a verbal Business Succession Plan evidenced by previous discussions, correspondence and the parties' conduct in taking out personal insurance. The potential effect of such a finding may be that the Death Benefit loses its CGT exempt status in the hands of the Life Insured (or their Estate) due to the insurance proceeds being received by a party who the Court has determined was not the sole "*beneficial owner*" of the policy.

It has been suggested that approximately 90% of all Business Succession Planning Cover is maintained without any written Buy/Sell Option Agreement in place. If you fall within this group it is not too late to act. Call us today to discuss your Business Succession Plan.

Contact Us:

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