



Offering Business Succession Services to your SME clients

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Succession in broad terms means a business owner's exit from the business. For business owners, their business or interest in a business is likely to be their biggest asset or retirement nest egg. It is essential that any transition in ownership runs smoothly, not only to maximise business growth and value, but to ensure the survival of the business.

BUSINESS SUCCESSION PLANNING IN AUSTRALIA

Surprisingly, there is a lack of business succession planning in Australia.

The Cameron Research Group periodically conducts research of Australian Small/Medium Enterprises (SMEs) and its research released in 2008 revealed there are plenty of succession planning opportunities for financial advisers to instigate with their clients.

- Only 10 per cent of SMEs have a documented business succession plan. The remaining 90 per cent can be divided in half:
 - those who have thought of succession; and
 - those who have given no thought to it at all.
- Only 22 per cent of SMEs have sought advice on succession planning, predominantly through accountants and financial advisers.
- Almost 70 per cent of SME owners plan to exit their business in the next decade.

VOLUNTARY VS INVOLUNTARY SUCCESSION EVENTS

Planned or voluntary succession events such as retirement, resignation or sale of interest are generally dealt with in the shareholders', partnership or unit-holders' agreement which regulates the relationship between the owners.

Certain parts of these agreements can be difficult and time-consuming to negotiate, especially if all the owners of a business are operating effectively and on friendly terms. For example, the agreement might stipulate terms and conditions of resignation such as who gets first right to acquire the exiting party's equity interest and on what terms, notification period, intellectual property, restraint clauses and so on. In other words, the owners have to imagine what would happen in situations that may be fairly acrimonious.

Some involuntary succession events may be contained in the agreement that deal with conduct of the owners (e.g. improper conduct, bankruptcy).

A crucial issue for most of the above succession events is funding for the acquisition ('vendor's terms'). An exiting owner may, for example, be paid in instalments over a period of time - conditional on his/her observance of the agreement's restraint of trade clauses.

FUNDED, INVOLUNTARY SUCCESSION EVENTS

Insurance can be arranged to potentially fund the acquisition of an exiting owner's interest in the business. This can occur where the exit is due to certain involuntary events, namely an owner's:

- death or terminal illness;
- Total and Permanent Disablement (TPD); or
- critical illness or trauma.

Given that any of the above three events could happen to any owner at any time, putting together a Buy-Sell agreement that is agreeable to all parties is a relatively simple matter. The Buy-Sell agreement should cover the rules concerning the transfer of an owner's interest in the business in the event of death, disablement or illness.

Succession planning in this category can generally be completed with relative speed and unanimity between the owners. This is in contrast to the broader agreement encompassing voluntary and unfunded involuntary events where agreements may deal with various contentious issues.

THE ROLE OF THE FINANCIAL ADVISER

The role of the financial adviser in providing advice on business succession is to either:

- identify which clients need a funded Buy-Sell agreement in their SME client base and arrange the insurance that funds the agreement; or
- arrange the insurance after an SME client has been referred to them by the SME's business adviser, (e.g. their accountant) or other advisers such as the SME's general insurance broker.

The adviser is then required to hold joint discussions with the client's accountant and collect accurate business data. Advisers must also help the client understand what information and documents need to be provided to a lawyer to allow efficient drafting of legal documents and reduce unnecessary time costs.

BENEFITS OF THE BUY-SELL AGREEMENT

It is important for the adviser to point out the benefits of a funded Buy-Sell agreement to the business owners. These benefits can include:

- stabilising the business and helping it to continue as a viable operation after the (often sudden) loss of a key person;
- reducing the risk of ownership disputes;
- reducing the risk of disputes about the value of the business;
- enabling the remaining owner(s) to acquire the departing owner's interest in the business; and
- ensuring the departing owner or his/her estate/dependants receive adequate financial compensation for the disposal of their interest in the business.

CASE STUDY: ALEX AND BILL

Alex and Bill each own 50 per cent of the shares in a successful business. When Bill dies unexpectedly, his wife Lynn inherits his shares in the business, via his Will. However, Lynn doesn't have the skills (or the time) to help run the business. Also, Alex doesn't have enough funds to buy out Lynn and is unable to borrow the money.

To further complicate matters, Lynn is entitled to the same management rights and share of profits as her deceased husband, while Alex is doing 100 per cent of the work and only receiving 50 per cent of the profits.

A better approach would have been to execute a Buy-Sell agreement, funded by insurance. By using this strategy, Lynn could receive the insurance proceeds in exchange for handing over her interest in the business to Alex. As a result, Lynn would be fully compensated, while Alex would take ownership of 100 per cent of the business and receive 100 per cent of the profits.

Case studies such as the one above are an all too common occurrence. According to the Cameron Research Group:

- Only 9 per cent of SMEs with multiple owners have Buy-Sell insurance.
- Over 60 per cent of SMEs have ever heard of Buy-Sell insurance.
- When the concept of Buy-Sell insurance is explained to the owners, "they are quite positive about it...some suggesting that this is exactly the type of issue that their accountant should bring to their attention".

THE ROLE OF OTHER PROFESSIONALS

Whilst **financial advisers** may identify and explain the need for business succession planning, Buy-Sell agreements and the related insurance (often referred to as 'ownership protection'), it is important they confine their advice to areas in which they are authorised to provide it.

Advice can be offered to clients in the following areas:

- the benefits of a Buy-Sell agreement;
- the benefits of funding this agreement (where possible, by insurance);
- types of insurance available and the most appropriate insurance for the client's needs;
- who, or what entity, owns the policies and associated implications (including taxation of proceeds, as this may necessitate the need to recommend a higher sum insured);
- the need for a Will, power of attorney and health directive; and
- the need for adequate, appropriate personal insurance.

THE ACCOUNTANT

The **accountant** may have referred the SME client to the financial adviser but the accountant's role is to also ensure that the SME structure is accurately depicted and understood.

The owners of an SME may think of it as 'their business' but the reality is the typical Australian business with multiple owners involves many entities. For example, the ownership entity may be a unit trust, the units of which are owned by the proprietors' various family trusts. The unit trust may own the various operating entities, such as companies.

It is also important for the accountant to identify proprietor loan accounts (e.g. shareholder loan accounts, beneficiary loan accounts). If we continue the example, a family trust (or the family trust's appointer) may appear to control the units it holds in trust, but if the family trust owes large amounts to its beneficiaries, those beneficiaries may have effective control of the trust if those loans are at call.

The accountant also often assists in providing information about the valuation of the business. This should be regularly updated or reviewed and, ideally, a formula (such as a multiple of earnings before interest and tax) can be included in the agreement.

If a robust formula agreed by all parties is not included in the agreement, valuation disputes will almost certainly arise in the event an owner exits the business.

THE SOLICITOR

Preparation of legal documents is **the solicitor's** domain. The financial adviser will often be required to 'project manage' the briefing of the solicitor so that the appropriate Buy-Sell agreement (one that is consistent with the insurance recommended, and outcomes required by the SME owners) is prepared.

It is important that the insurance is completed in close conjunction with the agreement, as it is an interlocking and integral component of the Buy-Sell agreement.

IMPEDIMENTS TO ARRANGING BUY-SELL AGREEMENTS

Beyond the realisation that the insurance and agreement will cost the owners money, issues may arise where:

- insurance cannot be obtained for all the owners of a SME; or
- insurance is more costly for some owners than others.

NOT ALL OWNERS CAN OBTAIN INSURANCE

An experienced adviser may have identified this potential issue from the beginning – by asking the owners a few basic questions about their health – and set expectations accordingly.

The adviser will have then provided the underwriters with evidence for the need for cover, having submitted all of the relevant financial statements for the business.

Before going back to the owners with the news that insurance cannot be obtained for one (or more) of them, the adviser will have already negotiated with the underwriters. If, for example, death and TPD has been declined, can the owner/s receive life cover only? With a loading? With exclusions?

If the un-insurability of one or more of the owners remains an issue, the adviser should reiterate that a Buy-Sell agreement can still minimise risks to both the business and a departing owner.

There is still the risk of death, disablement or trauma for the insurable owners to navigate and, in any case, the agreement will provide alternative funding (in lieu of insurance) should the uninsurable owner be the one to exit the business.

RE-DISTRIBUTING THE COST OF INSURANCE TO ADDRESS OWNERSHIP IMBALANCES

From the insurable owners' perspective the cost of the premiums could be pooled, so that the un-insurable owner chips in towards the cost of funding the agreement. The un-insurable owner might do this in return for agreeable terms if he/she needs to buy his/her co-owners out, should one of them die, become disabled or suffer a trauma.

As we examine some of the different ways of structuring Buy-Sell agreements, we will discuss the way an adviser might diffuse the issue of disparate premiums where all owners are insurable.

METHODS OF ARRANGING BUY-SELL AGREEMENTS AND INSURANCE

1. Cross Ownership of Insurance Policies

This is a traditional and logical method of arranging ownership protection and structuring a Buy-Sell agreement.

On death, disablement, or trauma of an owner, the other owners own the policy on the affected owner's life and claim the proceeds with which they can acquire the affected owner's interest in the business.

However, cross-ownership is not generally a popular option due to taxation considerations.

Tax Treatment of Premiums	Tax Treatment of Insurance Proceeds
<ul style="list-style-type: none"> → Premiums are not deductible. → If paid for by the business, premiums are deductible but subject to Fringe Benefits Tax (FBT). 	<ul style="list-style-type: none"> → Life and terminal illness proceeds are exempt from Capital Gains Tax (CGT) unless the policy has been acquired for consideration. This loss of exemption may be relevant if a new owner comes into a business that has an existing Buy-Sell agreement. → TPD and trauma proceeds are subject to CGT unless received by a defined relative of the life insured.

2. Self-Ownership of Insurance Policies

This is a more popular, tax-friendly option than cross-ownership.

The owners effectively pay for the insurance that will fund their own exit from the company. If elderly owners object to this option, it should be pointed out that they have the greater interest in the Buy-Sell agreement being in place as an adverse event is more likely to happen to them than their younger or healthier co-owners.

If the objection is strong, a pooling of the premiums is easy to arrange, whereby the owners paying greater premiums have their package adjusted upwardly and/or the owners paying lower premiums have their package adjusted down.

Tax Treatment of Premiums	Tax Treatment of Insurance Proceeds
<ul style="list-style-type: none"> → Premiums are not deductible. → If paid for by the business, premiums are deductible but subject to FBT. 	<ul style="list-style-type: none"> → Life and terminal illness proceeds are CGT exempt unless the policy has been acquired for consideration. This loss of exemption might be relevant if the owners have moved from a cross-owned to a self-owned Buy-Sell agreement. → TPD and trauma proceeds are CGT exempt.

On claim, the receipt of the insured proceeds by the insured or his/her beneficiary can either be:

- treated as 'deemed consideration' for the acquisition of the exiting owner's interest in the business by the continuing owners; or
- handed over to the continuing owners so they can acquire the exiting owner's interest in the business.

The disposal of the business interest for CGT purposes is always at market value. Where the proceeds do not equate to market value, the market value substitution rule applies.

Where the insurance proceeds are less than market value, the Buy-Sell agreement can specify that either:

- the exiting owner will only receive the insurance proceeds; or
- the continuing owners will pay the balance owing (after the insurance is taken into account) – usually in instalments.

3. Super Ownership of Insurance Policies

This is essentially the same as self-ownership, but the policies are held by the owners' super funds. One constraint is that trauma or critical illness insurance is generally not available from super funds, although some insurers offer the ability to connect self-owned trauma cover to super-owned life and TPD cover at extension (rather than stand-alone) rates.

As an aside, many, if not most, Buy-Sell agreements do not include funding for trauma as this is the most expensive cover. Additionally, a business owner may recover from a trauma (such as heart attack or cancer) and return to work, so it may not be a succession event. However, there are techniques available to include, and effectively fund for, trauma in a Buy-Sell Agreement which space does not permit us to examine here.

The (life and TPD) premiums are paid by the super fund for which the fund trustee obtains a tax deduction. The effect of this fund deduction is to offset contributions tax on any Concessional Contributions (CCs) that are made to the fund to help it pay for the premiums.

The abolition of Reasonable Benefit Limits (RBLs) in 2007 means unlimited tax-free death benefits can be provided to certain beneficiaries, referred to as 'death benefit dependants' in tax law. These include:

- married and de facto spouses, and (since July 2008) same sex couples in a registered or genuine domestic relationship;
- children under 18;
- financial dependants (including children 18 and over); and
- people in an interdependency relationship with the deceased just prior to the deceased's death.

It also means less tax on lump sum TPD benefits which were tested against far lower RBLs than death benefits. There is no tax on lump sum TPD benefits paid to people aged 60 and over.

Tax Treatment of Premiums	Tax Treatment of Insurance Proceeds
<ul style="list-style-type: none"> → Life and TPD premiums are deductible (in the fund). → Concessional employer and personal contributions are fully deductible and do not incur FBT. → Concessional employer and personal contributions above the \$50,000* per annum cap (\$100,000 per annum for people aged 50 and over until 2011/12) are taxed at 31.5 per cent and count towards the fund member's Non-Concessional Contribution (NCC) cap (\$150,000* per annum). 	<ul style="list-style-type: none"> → Death benefits to dependants and terminal illness benefits are tax-free. → Death benefits to non-dependants are taxed at 16.5 per cent to 31.5 per cent. → Lump sum TPD benefits are tax-free for persons aged 60 and over. For people aged under 60, the benefits have a Tax-Free and Taxable Component (taxed at a maximum rate of 21.5 per cent).

* = Indexed to Average Weekly Ordinary Time Earnings (AWOTE)

The tax savings and other benefits of arranging ownership protection via super can be significant, as the following Case Study shows.

CASE STUDY: HELEN

Helen is a 44 year old business owner employed by her business entity. Her ownership protection premium for \$1,000,000 is \$5,000 per annum. Her Marginal Tax Rate is 41.5 per cent.

The following table compares insuring for various death benefit scenarios:

Type of Ownership Protection	Effective Pre Tax Cost of \$5,000* Premium
Self-owned	$\$5,000 / (1 - 0.415) = \mathbf{\$8,547}$
Self-owned but entity pays her premium	$\$5,000 \times 1.8692 = \mathbf{\$9,346}$
Super-owned within \$50,000* CC cap with non-dependant beneficiaries (worst case scenario)	$\$500,000 / (1 - 0.315) = \$729,927$ grossed up insurance to ensure \$500,000 net of tax is received Premium = $\$5,000 \times (\$729,927 / \$500,000)$ = $\mathbf{\$7,299}$
Super-owned above \$50,000* CC cap (i.e. excess contribution tax) with dependant beneficiaries	$\$5,000$ + $\$1,575$ excess tax paid by fund ($\$5,000 \times 0.315$) = $\mathbf{\$6,575}$ $\$5,000 + \$1,575$ excess tax paid personally $\mathbf{\$2,692}$ (i.e. $\$1,575 / (1 - 0.415)$) $\mathbf{\$7,692}$
Super-owned within \$50,000* CC cap with dependant beneficiaries	$\$5,000$

* = Per Annum

As can be seen, super ownership provides a cost effective solution even where:

- the entire benefit is taxed at 31.5 per cent (which would be the case if Helen was in partnership or had just established the business entity, had non-dependant beneficiaries and died immediately after taking out the policy); or
- the contribution made is above Helen's \$50,000 per annum CC cap (which she may be using for investment purposes).

Super is not for everyone. For example, if Helen had non-dependant beneficiaries **and** funded the premium with an excess contribution, the outcome is worse than any of the scenarios above.

OTHER POTENTIAL BENEFITS OF SUPER-BASED INSURANCE OWNERSHIP

- If the fund has an investment balance, the fund can continue paying premiums without contributions being made (which may be important if cashflow is tight).
- Most dependent beneficiaries can choose to take some, or all, of their benefit as a tax-effective pension.
- Proceeds are protected from creditors.
- Enhanced access to Centrelink benefits.

CONCLUSION

It is important that SME business owners are aware of the value of succession planning, and particularly the benefits of having a Buy-Sell agreement in place when planning for involuntary succession events such as death, disablement or trauma of an owner.

Arranging a Buy-Sell agreement is most effective when the financial adviser, accountant to the business, and solicitor drafting the agreement, work as a team.

Where succession of ownership can be funded by insurance, the structure of the agreement and policy ownership has significant implications for the business owners in terms of cashflow, tax effectiveness and succession event outcomes.