Business Succession Planning

All businesses need a succession plan

All business proprietors will experience a succession event at some point, either due to death, illness or disability (an involuntary event), as a result of an equity sale or retirement (a voluntary event) or a 'default' event (a breach of an agreement between the proprietors). Voluntary/planned trigger events and default events are generally dealt with in a separate shareholder or unit holder agreement, while a buy/sell option agreement deals with involuntary trigger events.

It is important to have both agreements in place to cover transfers of business interests in all circumstances.

This information sheet deals with the following:

1. Shareholder agreements

1.1 What is a shareholders agreement?

- A contractual agreement between the shareholders of a company dealing in particular with the ownership and transfer of those shares and other issues relating to the running of a company. The proprietor's interest is in the form of shares in a company, but a similar unit holders agreement may be implemented for units in a unit trust.
- **Shareholder agreements usually incorporate some or all of the following:**
  - ◊ How shares are to be issued, owned and transferred by shareholders
  - ◊ Default and potential buy out of a shareholders interest
  - ◊ Sources of funding for the business
  - ◊ Structure of a board of directors, including the number of directors, requirements to become a director, the procedure for subsequent appointment and termination of directors
  - ◊ Management and possible limitations on the powers of the board of directors
  - ◊ Specific policies on various shareholder issues, including voting powers and whether simple majority resolutions or special resolutions are required in terms of the Corporations Act
  - ◊ Administrative matters, e.g. who will be the company secretary?
  - ◊ Financial management and accounting
  - ◊ Whether an annual plan and budget is required
  - ◊ Confidentiality issues
  - ◊ Dispute resolution procedures
  - ◊ General provisions.

1.2 Advantages of shareholder agreements

- Minimise uncertainty for the business operation.
- Clarity for all parties, particularly in respect of voluntary departures from the business by shareholders, (e.g. resignation as a shareholder) or 'default' departure from the business (e.g. as a result of a breach of one of the material terms of the shareholders agreement).

HICKS OAKLEY CHESSELL WILLIAMS
Lawyers & Notary

Contact us at:

Melbourne Office
Phone: 03 9629 7411
Google Map Link

Level 18
461 Bourke Street
Melbourne 3000

Fax: 03 9629 7422
DX: 31331 Mid-town
PO Box 16067
Collins Street West 8007

Mt Waverley Office
Phone: 03 9550 4600
Google Map Link

Central 1, Level 2, Suite 17
1 Ricketts Road
Mt Waverley 3149

Fax: 03 9544 8711
DX: 32002 Mt Waverley
PO Box 2165
Mt Waverley 3149

enquiries@hocw.com.au
www.hocw.com.au

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2. Buy/sell option agreements

2.1 What is a buy/sell option agreement?

- A contractual arrangement between the proprietors of a business under which a proprietor's interest in the business will transfer to the other proprietors, upon the occurrence of a specified trigger event (for example death, total and permanent disability (TPD) or a trauma event of an outgoing proprietor). The proprietor's interest may be in the form of a partnership interest, shares in a company or units in a unit trust.
- Buy/sell option agreements generally deal with involuntary (unplanned) trigger events (i.e. death, TPD or a trauma event) as opposed to voluntary/ planned trigger events such as retirement, resignation, personal bankruptcy, or breach of a shareholder/unit holders agreement.
- The transfer of interest is funded by way of proceeds from insurance cover held by or on behalf of the proprietors.
- **The optional aspect of the agreement enables a buy/sell arrangement to be adopted by use of:**
  - ◊ A 'put' option (also known as a 'sell' option) whereby an outgoing proprietor (or their estate) has the right to require that their interest in the business be acquired by the ongoing proprietors, and
  - ◊ A 'call' option (also known as a 'buy' option) whereby the ongoing proprietors have the right to acquire the interest in the business held by the outgoing proprietor.

2.2 Advantages of buy/sell option agreements

- Minimise uncertainty for the business operation.
- Provide funding for a change in ownership interest.
- Avoids an undesirable situation where ongoing proprietor cannot buy out the outgoing proprietor and could even end up with an outgoing proprietor's spouse somehow stepping in and performing the outgoing proprietor's role, where that spouse has no skills in the area concerned (it happens!).
- Clarity for the trustees of a deceased proprietor's estate.

2.3 Issues to consider

- Type of ownership interest to be transferred under the agreement (i.e. shares, units or partnership interest).
- Where there are more than two proprietors, whether the outgoing proprietor's interest will be offered in equal proportions to all ongoing proprietors or pro rata to their current holdings.
- Whether there are any key assets, i.e. land and buildings or intellectual property held outside the operating entity for asset protection reasons and, if so, how the transfer of interests in multiple entities will be dealt with.
- **Valuation of business interests, including the:**
  - ◊ basis (formula) upon which valuations will be carried out
  - ◊ timing of valuations and
  - ◊ identity of the valuer.
- Whether agreement will cover a trauma event as well as death + TPD NB: Can be uncertainty re ability to work after trauma events.
- Buy/sell option agreements provide that the purchase price for the interest will be reduced by the amount of the insurance proceeds received by the relevant proprietor or his estate. If the insurance proceeds are insufficient to cover the value of the outgoing proprietor's interest, the parties need to consider whether any potential shortfall at the time of departure will be made up by the remaining proprietor/s, or whether the proceeds of insurance cover will be the deemed equity value.
- Payment of salary and benefits. Consideration should be given to whether to pay salaries and/or dividends/distributions for a certain period if an option event occurs and the buy/sell agreement is 'triggered'. Provides cash for the departing proprietor or their spouse at a critical time (for example, payment to the earlier of either date of receipt of the insurance proceeds or a period of three months immediately following the option event).

- **How to deal with external and internal loans:**

  ◊ **External loans**
  The best option is for the operating entity to have its own insurance policy, so that if a proprietor suffers a trigger event, then the company receives the insurance payment. A so-called 'debt protection policy' is used to settle external loans to bank. It is recommended that the bank be granted a security interest (previously a charge) over the policy so the bank will have the right to payment and be a secured creditor. (NB: debt protection policy generally not referred to in the buy/sell agreement, as the proceeds will not be used for equity purposes. Referred to in shareholder agreement).

  ◊ **Internal loans**
  The liability of a deceased proprietor who owes money to the operating entity, or the right of the proprietor to be paid a loan account owned to the proprietor carries over to the deceased estate in the event of death. This is often not documented by loan agreement, so the buy/sell agreement can include terms as to how loan is repaid (could be forgiven, repaid partially, repaid over time, or a combination of these). (NB to document the loan as a separate loan agreement as well).

- How life/TPD insurance premiums to be paid (generally by each proprietor).

2.4 Taxation issues

The main Capital Gains Tax (CGT) issues:

2.4.1 Whether CGT is payable on the insurance proceeds

- **Life insurance proceeds**
  A capital gain arising from a CGT event which occurs in respect of a 'policy of insurance on the life of an individual' will be disregarded if the taxpayer is:
  ◊ The **original beneficial owner** of the policy, or
  ◊ An entity which acquired the interest in the policy for no consideration.
- **Trauma insurance proceeds**
  A capital gain in respect of trauma insurance proceeds is disregarded where it arises from a CGT event relating directly to, inter alia, compensation received for any injury or illness suffered by a person or their relative.

2.4.2 Whether CGT is payable on the sale of interest in the business

If an interest in the business is sold to the ongoing proprietors, following the death or other defined event of one of the proprietors, then CGT ordinarily paid by the selling proprietor (or his estate) is calculated in accordance with the normal CGT rules.

2.4.3 Payment of CGT on sale of interest

CGT is payable on market value of the shares or units, so if market value has increased, but the insurance levels have not been increased to reflect this, then tax must be paid from other sources. This tax liability should be taken into account when reviewing the level of each person's insurance each year.

2.5 Insurance

2.5.1 Funding alternatives

- Self insurance (self insurance generally the safest tax option, and hence the most common)
- Cross insurance
- Special purchase trust
- Operating entity
- Superannuation fund

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Melbourne Office
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Google Map Link

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114 William Street
Melbourne 3000

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DX: 31331 Mid-town
PO Box 16067
Collins Street West 8007

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enquiries@hocw.com.au
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2.5.2 Ownership of insurance policy - better for policies to be self owned
Avoids possible tax implications associated with cross ownership, company ownership or by other entity.

2.5.3 Insurance premiums are not tax deductable
(because the cover is for a capital purpose).

2.5.4 Insurance proceeds do not affect the CGT liability of the outgoing shareholder where deemed 'market value' provisions apply and for ongoing proprietors, they are effectively acquiring an asset for nothing and have a zero costs base with CGT issues of their own.
(NB: It is important to ensure that the market value of business is assessed each year and insurance policies updated accordingly. Consideration should also be given to 'grossing up' the amounts insured under the life policies to cover any CGT liability of the outgoing proprietor).

3. The 'planning' in business succession planning - the 'big picture'

3.1 Points to note

- Every succession plan is different, as each business has a different set of circumstances, which need to be taken into account, including the number of proprietors, type of business, existing business structure, economic factors and the personalities of the owners, their staff and families.
- It is important to have an overall succession plan in place, in addition to a Buy/Sell Agreement and Shareholder or Unit Holders Agreement.

3.2 Advantages of a succession plan

Clear communication and planning well in advance means a transition can be executed with minimal disruption to the business and also maximises value for the business and can fund a retiring proprietor's retirement.

3.3 What should a succession plan cover?

A succession plan should be versatile enough to deal with both planned and unplanned events, including the following:

- Sale of business to external third party
- Sale of equity and business to existing partners or a new partner
- New partner entering business
- Family business transition to next generation, and dealing with business/equity share of deceased partner of a business.

3.4 Implementing a succession plan

Ideally business proprietors should start to plan for succession events well in advance of retirement or exit. One of the most important issues when entering a business is the ultimate exit for proprietors.

Succession plans can be considered in four phases, namely:

- **Exploration phase**
This includes communication between all stakeholders, business owners, spouses and key employees to discuss their goals and plans to retire or exit the business. Involves considering both unexpected and expected circumstances, which can be difficult and confronting, (e.g. breakdown of the relationship between the business owners, or even a proprietors personal relationship with a spouse). The communication process allows the plan to reflect the goals of the parties and plan for anticipated changes, including expected retirement dates, recruitment programs and goals for the transition period.

- **Valuation phase**
  The business proprietors then need to know how much the business is currently worth. A valuation is useful for a number of reasons, including implementation of a valuation methodology in a shareholders or unit holders agreement and considering issues as to how an exit from the business may be funded, particularly if a proprietor owns a significant share of the business.

  Such methods might include:
  ◊ Payment of equity in tranches over extended periods of time
  ◊ Employee share ownership plans (for internal succession)
  ◊ Employee bonus/incentives awarded in equity, and
  ◊ Vendor's terms contracts.

- **Reviewing phase**
  This phase is implemented concurrently with the valuation phase and includes a multi-disciplinary approach involving all relevant advisors, including business consultants, lawyers, insurance brokers, accountants and financial planners. It is often a good idea to have a project co-ordinator who could be a well qualified and competent business consultant.

  During the reviewing phase the following issues are considered:
  ◊ Whether the existing business structure provides a tax effective exit strategy
  ◊ Whether the proprietor’s personal tax structure allows for a tax effective receipt of a payment
  ◊ Whether the existing business structure and legal agreements allow for the entry of future partners
  ◊ Whether the business plan reflects the succession plan
  ◊ Whether existing agreements and documents clearly set out the succession process and provide for an equitable and smooth transition of equity.

- **Implementation Phase**
  Once the succession plan has been mapped out it should be documented clearly, which can include the following:
  ◊ A written succession plan, including time frame for planned succession events
  ◊ Shareholder or unit holder agreements (or amendment of existing agreements)
  ◊ A buy/sell option agreement
  ◊ A sale of business agreement or a sale of shares agreement (if the entire business is being sold or transferred to a third party)
  ◊ Relevant wills and powers of attorneys for business proprietors
  ◊ Employee share ownership plans, and
  ◊ Restructuring where necessary to provide for the best tax outcome.

3.5 Dealing with family businesses

Family businesses generally have other considerations, which are not involved in non-family businesses. These often include delicate emotional issues, which mean that family businesses are ill-equipped to deal with succession events. Family businesses therefore often benefit from an independent party who can act as a referee in succession planning discussions and deal with the difficult questions and decisions which sometimes need to be made. These issues include:

- Does the younger generation want to stay in the business?
- Is the younger generation expected to pay for the business at market value?
- Can they afford to do so?

HICKS
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Contact us at:

Melbourne Office
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Melbourne 3000

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DX: 31331 Mid-town
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- Is the younger generation capable of running and growing the business?
- Older generation intending to give equal shares to the younger generation, sometimes regardless of ability or contribution.
- Complicated relationships (including in-laws, sometimes).
- Younger generation often work at below market salary on expectation that they will own the business one day. Is this expectation justified and has it been discussed?

3.6 Benefits of succession planning

- If an external sale is contemplated the price for the business will be maximised.
- Any inadequacies in the business structure should be identified during the valuation and reviewing phrases. These can be rectified prior to a sale.
- A succession plan which focuses on internal succession and grooming of potential new proprietors from the pool of employees provides incentives for star performers to remain in the business and continue to perform well.
- In the case of a family business, the succession plan is known to all and there are no surprises left to be disclosed in a Will. Such surprises can lead to discontent and destroy family relationships and/or the performance of a business.

3.7 Consequences of no succession plan

- Possible delay in exiting the business for a proprietor.
- Reduced value of business for sale to a third party.
- Unnecessary and unfortunate tax consequences upon selling the business.