




Attwood Marshall
LAWYERS

A Business Succession Guide



DON'T EUTHANISE YOUR BUSINESS



"The most important benefit of a Business Succession Plan is to provide certainty for everybody involved."

A Business Succession Guide

A recent study of 570 family businesses has revealed only 30% of businesses had any formal business succession or exit strategies in place.[1]

In this Guide we will attempt to highlight the importance of Business Succession and to provide some practical guidelines on how to implement a successful business succession plan in your business.

Planning for the unexpected is a valuable instrument in any business. Not only does it provide comfort and peace of mind to all partners[2] in the business but it also creates security for the business financiers.

We find that more often than not financiers will insist on a Business Succession Plan before providing any funds to a business. By having a Business Succession Plan in place, it may provide comfort to the financier and make any finance application easier.

We live in a real world and not a perfect world and therefore if any business owner ignores the opportunity to plan for the succession of its business such business owner leaves the business susceptible to self-destruction. This has on numerous occasions been referred to as "business euthanasia".

A Benefit To Business

It is important to know what is a Business Succession Plan and how will such a plan be to the benefit of the business.

In summary, a Business Succession Plan is in effect a financial and tax plan that:-

- Gives the business every chance of survival if any of the partners dies, suffers a permanent disability or trauma (referred to as an "event").
- It ensures the true value of the interest of such a partner in the business is received by its family members;
- It allows for transition of ownership without the additional financial obligation to compensate the relevant partner or its estate for its share in the business;
- It provides comfort to all parties involved (including staff) and the financier of the business;
- It structures the affairs of the business to reduce unnecessary capital gains tax, income tax and stamp duty for the remaining partners and the relatives of the partner that suffered an event.

The most important benefit of a Business Succession Plan is to provide certainty for everybody involved. A verbal plan is not enough. One of the partners to such a "verbal plan" will not be around to confirm what was discussed and this opens a field mine for lawyers to litigate until such time that there is no value left in the business.

The first requirement is therefore that a Business Succession Plan should be in writing signed by all parties and their closest relatives. A personal Will is not enough, a business Will is required to allow for the successful succession of your business.

A Business Succession Plan should address at least the following:-

1. The interest of the departing partner and his or her family;
2. The interest of the surviving partner and his or her family;
3. The impact of personal guarantees provided by the departing partner. (It is not well-known that in the fine print of most bank documents there is usually a clause stating if an event occurs to any of the partners ("the departing partner") in the business it may constitute a default under the agreement and the bank is entitled to insist on repayment of the loan or additional security.

The following are some alarming statistics:[i]

No of Partners	Chance of one partner dying before age 65	Chance of one partner dying or becoming totalling disabled before age 65
2 partners	35 in 100	52 in 100
3 partners	47 in 100	67 in 100
4 partners	47 in 100	77 in 100
5 partners	66 in 100	84 in 100
6 partners	77 in 100	89 in 100


To deal with the issues raised above, and raised in Part 1 of this series, we always recommend to business owners to enter into a Buy/Sell Agreement. This Agreement is in effect a Business Will that provides for the continuance of the business after the happening of an event and secures the continuance of the business with minimum interruption.

Consider the following scenario:-

Joe and Tim are partners in a business. Both are married and Joe's daughter is a second year law student at a well-known university in Qld.

Joe is involved in a car accident on the way to work and suffers severe injuries. After being in a coma for 4 weeks Joe eventually passes away. In his Will he left everything, including his share in the business, to his wife ("Modest"). Any of the following scenarios can now occur:- (this is not meant to be an exhaustive list)

- Modest is prepared to sell Joe's share in the business to Tim but she believes Joe was the "rainmaker" in the business and therefore his share in the business was worth \$1 million. She is only prepared to sell it to Tim for \$1 million. Tim on the other hand believes Joe was always dragging the chain and his share in the business is worth nothing more than \$100,000.
- After discussing the matter with her daughter (and obtaining 'competent legal advice' from her daughter) they decided her daughter will step into the shoes of Joe and continue with the business. Tim (60 years of age) has no interest in continuing with the business with Joe's daughter as a partner, especially because she has already indicated she will "get the business back on track".
- Joe has provided personal guarantees to the bank for the overdraft of the business. The bank has now indicated that Tim has 21 days to provide alternative security or the overdraft should be repaid.



A Partnership or Shareholders Agreement is a working document and is in operation whilst the partners are still continuing with the business.

The only way to avoid any of the above scenarios is to enter into a Buy/Sell Agreement where the parties agree to the following:-

1. Each partner gives an option to the other partner to buy its share in the business;
2. Each partner gives an option to the other partner or its estate to insist that the ongoing partner buy its share in the business;
3. What events will trigger the working of the Agreement;
4. How the business interest of a partner will be valued;
5. How the continuing partner will fund the purchase of the departing partner's share in the business;
6. The spouse or closest beneficiaries of the partners to agree and sign off on the Agreement.

It must always be remembered that a Partnership or Shareholders Agreement is not the agreement to deal with the issues raised above.

A Partnership or Shareholders Agreement is a working document and is in operation whilst the partners are still continuing with the business. It deals with the day to day running of the business with exit strategies that do not fall under any of the events discussed above.

A Buy/Sell Agreement only kicks in on the happening of an event and the relevant date is the date of the event. As we will discuss later, the date is important from a tax and stamp duty.

The following are some of the issues that should be addressed in a Buy/Sell Agreement:

1. The parties to the Agreement (including spouses and beneficiaries);
2. The events that will trigger the working of the Agreement;
3. Put and Call Options;
4. How to determine the value of the business and a partner's interest in the business;
5. The most appropriate funding mechanism to finalise the transfer of the business.

The two most important elements of a Buy/Sell Agreement

Determination of the value of the business; and

The funding options available for the purchase of a partner's interest in the business.

How to determine the value of a business for purposes of a buy/sell agreement:-

This is arguably the most important part of the Buy/Sell Agreement. By getting this right all disputes regarding the value of a deceased partner's interest in the business are eliminated and all parties involved will know exactly what is going to happen (from a financial perspective) if an event occurs. Generally speaking there are 3 methods that may be used to provide an acceptable way to agree on a realistic business value:

1.1 Agreed Formula

The business owners in consultation with their accountants may agree to use a specific formula that reflects an industry standard or a formula that is appropriate to the business in question. If a formula like this is used it is important to review the formula on a regular basis to ensure it remains current and relevant to the business. It must be noted that the use of an agreed formula may create an issue depending on the means of funding that will be available for the purchase of a deceased's interest in the business. If insurance is going to be used (as discussed below) to fund the purchase/transfer of the business, the agreed formula should be used to determine the value from the commencement date of the Buy/Sell Agreement and thereafter on a regular basis. It is important not to apply the agreed formula only on the happening of an event.

1.2 Agreed Dollar Value

The business owners agree to a specific dollar value of the business. Usually the agreement provides for a review of this amount on a regular basis depending on the type of business. This may take place every quarter, six months or yearly. This may take place every quarter, six months or yearly.

The effect of an agreed dollar value method is the same as if an agreed formula is used from the commencement of the Agreement and is reviewed on a regular basis.

1.3 Independent Valuer

The parties may decide to have the value of the business be determined by a valuer on the happening of an event. The concern with this method is that the parties will most probably not be able to use insurance as a funding option. The main purpose of a Buy/ Sell Agreement is to provide certainty and this method of valuation falls short in that regard. In determining the value of the business and the ultimate price a departing partner should be paid for its interest in the business it is also necessary to consider the following:-

- The debts of the business, including any overdraft and/or bank loans;
- Personal guarantees that were provided by the departing partner and replacement of same;
- The financial costs to replace the departing partner.
- Where the parties have agreed upon the value of the business and the purchase price payable by the continuing partner, the next important element of a Buy/Sell Agreement is to put arrangements in place to fund the purchase of the departing partner's share in the business.

2. FUNDING OPTIONS

There are several options available and it depends on the financial status of the business and the partners which option will best suit the funding of the purchase of a deceased partner's interest in the business. The following are some of the options that may be available (this is not exclusive):-

- **Enterprise funding.** This means there is enough cash available in the business to provide for the purchase price.
- **Bank funding.** There is enough credit available from a financier.
- **Vendor finance.** Where the Agreement allows for the payment of the purchase price on certain terms and conditions agreed upon between the parties over a period of time.
- **Life insurance.** It is important to carefully consider which funding option will suit the business and the remaining partners in the business the best asset as it is conceivable that the wrong funding mechanism may bankrupt the remaining business partners. It is our experience that life insurance is a common source of funding in a Buy/Sell Agreement. It takes away any financial stress on the business and the remaining business partners and creates a fair, reasonable and quick finalising of the transfer of the business.

In essence, each partner takes out life insurance equal to the value of its interest in the business as agreed upon in the Buy/Sell Agreement. It is therefore preferred that the partners agreed on a specific dollar value or an agreed formula but only as discussed above.

The Buy/Sell Agreement provides that where an event occurs and the life insurance pays the proceeds to the relevant partner, its estate or beneficiaries, the proceeds received by the partner, his estate or beneficiaries will be deemed payment for his interest in the business.

His part of the business will then be transferred to the remaining partners without the financial strain to pay any additional amount to the deceased partner and/or his estate. When using life insurance as a funding mechanism it is important that the insurance policies be reviewed on the same basis that the Buy/Sell Agreement will be reviewed to ensure that the amount insured always equals the value of the as agreed upon between the business partners from time to time.

It is also important to discuss the ownership of life insurance policies in that there are different ownership structures that may be used. The preferred structure is self-ownership but we always discuss this with the business partner's insurance broker to ensure the correct structure is used for the insurance policies. It should be noted that an insurance policy for these purposes must be supported by a Buy/Sell Agreement.

An insurance policy on its own without a written agreement between the business partners will not be enough and may potentially have no effect on the transfer of a part of the business to the remaining business partners.

Where business owners have agreed upon the value of the business and insurance is in place to cover that agreed amount, it provides comfort and certainty to everybody involved in the business that financial strain will not have an effect on the continuance of the business when an event occurs.

It is not only important, but highly recommended that the effect of taxation should be considered as part of business succession planning and the impact it will have on the change of ownership of a business.

1. Policy Ownership

If insurance is used as the preferred way to finance a Buy/Sell Agreement it is important to consider the ownership of the insurance policy as the tax treatment of different ownership modules will be different.


2. Capital Gains Tax

One of the main reasons for entering a Put and Call Buy/Sell Agreement is that no binding agreement will come into existence for CGT purposes until such time that an event occurs.

As a result the time of disposal of the business for CGT purposes will be when a triggering event occurs which gives rise to CGT event A1.

Even though the granting of an option triggers CGT event D2, any capital gain or loss arising from the occurrence of event D2 is disregarded when the option is exercised.

There are several CGT concessions which may be available at the happening of CGT event A1 and business owners should obtain specific taxation advice in this regard.

A photograph of a person with grey hair lying on their back on a wooden lounge chair with a light-colored cushion. They are outdoors, and a swimming pool is visible in the background. The scene is bright and sunny.

There are several CGT concessions which may be available at the happening of CGT event A1 and business owners should obtain specific taxation advice in this regard.

Due to the CGT implications on the transfer of ownership in a business, it may be worthwhile considering the amount of the insurance policy that business owners will take out to provide for any CGT implications that may arise for the continuing business partner after the happening of an event.

3. Stamp Duty

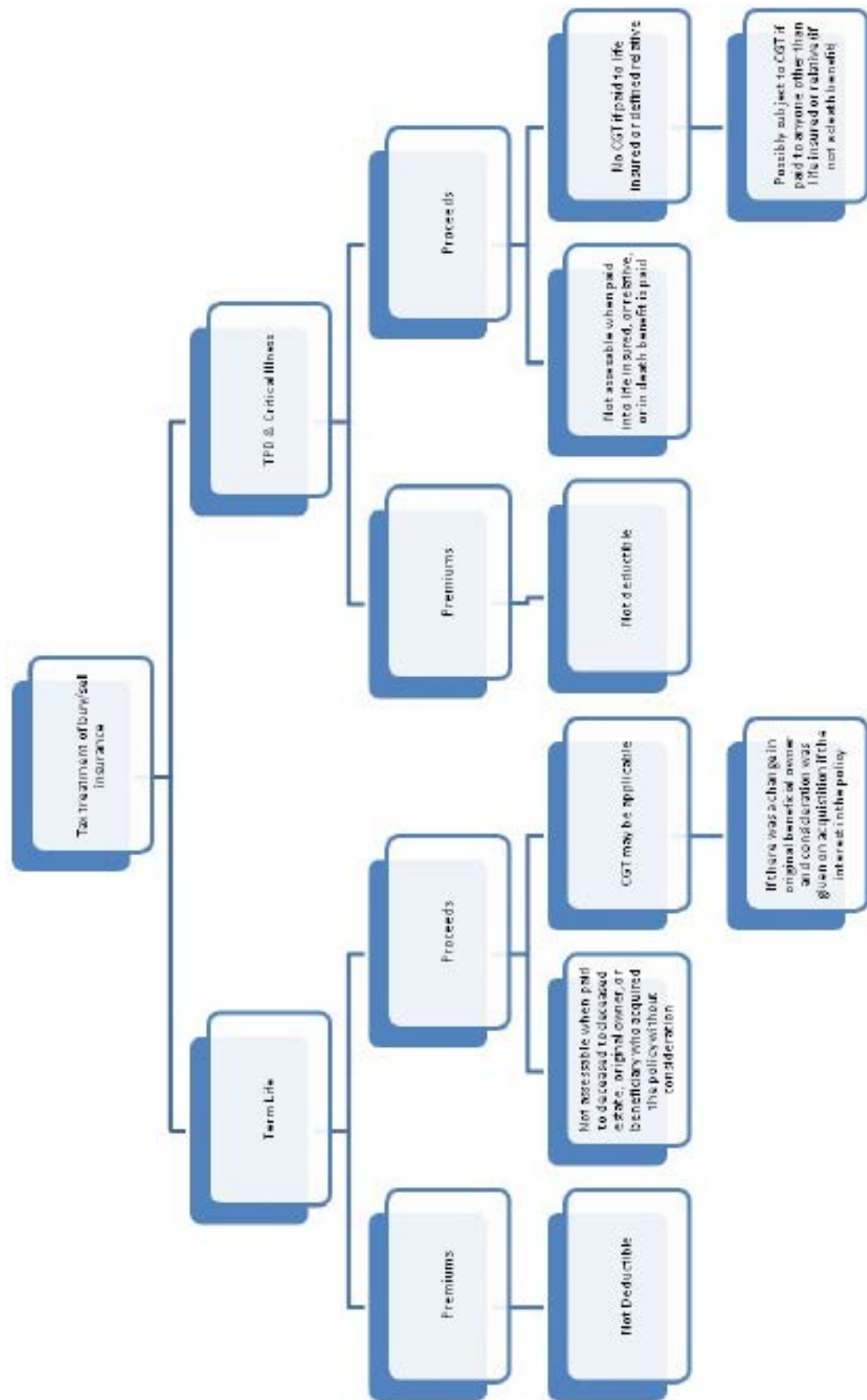
Section 124 of the Duties Act 2001 (Qld) provides that:-

“Transfer duty is not imposed on the following dutiable transactions:

(a) a transfer or agreement for the transfer of dutiable property to the extent that it gives effect to a distribution in the estate of a deceased person.”

Arguably the above section in the Act could be used to avoid having to pay stamp duty on the transfer of the share of business to the remaining partner.

Below is a brief outline of the tax treatment of a Buy/Sell Agreement.





Attwood Marshall LAWYERS

Family Law | Elder Law & Retirement | Estate Planning | Estate Litigation & Contesting Wills | Deceased Estate Administration
| Business & Commercial Transactions | Dispute Resolution & Commercial Litigation | Conveyancing | Compensation Law |
Thoroughbred Breeding & Racing

We acknowledge that in this series we have only discussed Buy/Sell Agreements. There are several related issues such as Key Person Insurance, Commercial Debt Forgiveness and Insurance Trust Deeds which we have not discussed.

These may be topics for future articles.

To end this series we quote the following:-

“Where there is no Business Will,
there is no way your business can rest in peace”.

Should you wish to discuss the succession of your business and the effect they may have not only on the other partners but also your relatives, please contact our Property & Commercial Department on 1800 621 071 or email info@attwoodmarshall.com.au for an appointment.

We will commence our seminars relating to business succession and Buy/Sell Agreements in April 2015. If you feel you or your staff/clients may benefit from such a presentation please contact us to arrange on 1800 621 071 or email info@attwoodmarshall.com.au.



Office Locations:

Coolangatta Office - Head Office
Suite 1, Level 2, The Strand
72 -80 Marine Parade
PO Box 334 Coolangatta QLD 4225
DX 41751 Coolangatta

Robina Office
Suite 11, Ground Floor, Eastside Building
232 Robina Town Centre Drive, Robina QLD 4226

Kingscliff Office
Suite 24, Level 2
Kingscliff Professional Centre
38 - 42 Pearl Street
PO Box 1413 Kingscliff NSW 2487

Brisbane Office
Level 27 Santos Place
32 Turbot Street, Brisbane QLD 4000