Modern family business succession planning for the blended or complex family

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1 Introduction

1.1 Statistics from the Australian Bureau of Statistics and Family Business Australia in 2012 stated that approximately 70% of Australia's businesses were considered a family business (which corresponded to approximately 1.5 million family businesses in Australia).[1]

1.2 Recent reports (quoting Family Business Australia) have stated the statistic that family businesses employ over 50% of the Australian workforce.[2]

1.3 These statistics highlights the importance family businesses have on the Australian economy and workforce.

1.4 With recent statistics stating that only around 30% of family businesses survive into the second generation and that around 12% would be viable in the third generation,[3] given the impact a failed family business would have to relevant family members and the family of employees, it is crucial that we, as advisors seek to assist our family business clients in having appropriate succession plans in place.

1.5 This paper focuses on considering the issues and decisions families need to face when implementing an appropriate succession plan. This will include the importance in getting the right structure in place (and how this may be achieved) as well as having appropriate strategies, documents and transition arrangements in place to enable a smooth passing of the business to the next generation.

1.6 This paper will be deliberately light on any detailed legal analysis (and is not intended to be an all-encompassing guide to the legal, tax, accounting and family issues that can arise) as a large focus on being the family's trusted advisor in these circumstances will be to understand the objectives of the family and business, managing such intentions with the various emotional issues that will inevitably come into play and engaging with the most appropriate professionals to put in place an appropriate plan.

1.7 This paper also includes three full client-based case studies (located the Annexure) as well as short client-based and popular media examples in the body of the paper.

1.8 For the avoidance of doubt, a reference in this paper to a:

(a) 'family head' will be a reference to the person in the family who is making the final decisions in relation to the family business and the direction for the family. While this is often the 'father', this can also include both father and mother; and

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[1] Based from Australian Bureau of Statistics Release 8175.0. Counts of Australian Businesses, May 2013; and Family Business Australia, 2012; the author was unsuccessful in locating more recent statistics on this matter but notes that a '98%' was used in relation to 'small business and family enterprises' in Australia (being businesses with less than 20 employees) in the Australian Small Business and Family Enterprise Ombudsman's 'Small Business Counts, Small business in the Australian economy' publication, July 2019

[2] https://www.mybusiness.com.au/management/6219-australia-marks-national-family-business-day; the author acknowledges that the association quoting the family business statistics is one that looks to represent family-operated businesses

[3] The age old saying '*the first generation makes it, the second generation spends it, and the third generation blows it*' comes to mind

(b) 'director' will be a reference to a person in a decision-making capacity, notwithstanding the structure in which the business operates from may use a different term.

1.9 Finally, if any State legislation is to be considered, this paper will only consider such legislation from a Queensland perspective.

2 Some statistics from a recent family business survey

2.1 Before considering the various issues facing a succession plan for family businesses, it is useful to appreciate some recent statistics that emphasise the importance of implementing a robust succession plan.

2.2 The following statistics were taken from a report issued by KPMG in May 2018 (**Report**).[4]

2.3 In relation to having appropriate '**leadership/management**' transition strategies in place, the Report:[5]

(a) found that 63% of the family businesses surveyed had '*some form*' of 'leadership transition/succession strategy' in mind;

(b) 29% of the family businesses did not have any strategy in place, which was likely due to the current leader being (on average) less than 55 years in age; and

(c) the remaining 8% of family businesses were looking to sell the business in the near future.

2.4 In contrast, the Report stated in relation to the '**ownership**' transition strategy:[6]

(a) nearly 32% of family businesses did not have any ownership transition strategy;

(b) of the family businesses that did have an ownership transition strategy, interestingly:

(i) 63% intended to pass the business to family members;

(ii) 5% intended to sell a minority share to non-family;

(iii) 3% intended to sell a majority share to non-family; and

(iv) 24% intended on either closing the business or selling.

2.5 It has to be said that the statistics in the Report fare much better than those even 10 years ago (whereby close to 80% of family businesses surveyed did not have 'leadership/management' transition strategies).

2.6 A large reason for this change can be attributed to the increased awareness of this issue as part of the generational shift, however, having a strategy in place does not automatically translate to having an appropriate plan.

2.7 Despite the increase in awareness, the Report noted **a lack of an appropriately documented plan** in relation to:[7]

(a) a unifying plan for the future of the business – over **83%** of family businesses surveyed lacked a plan;

[4] 'Family business – the balance for succession', KPMG, May 2018
[5] Ibid, page 11
[6] Ibid, page 11
[7] Ibid, page 13

(b) a unifying strategy for how family will participate/be recognised in the business – **86%** of family businesses surveyed lacked a plan;

(c) retirement plan for the current CEO or managing director – **73%** of family businesses surveyed lacked a plan;

(d) preparing and training a successor before succession takes place – **50%** of family businesses surveyed lacked a plan;

(e) the process for appointing a new CEO or managing director – **63%** of family businesses surveyed lacked a plan;

(f) the ownership transfer or sale – **74%** of family businesses surveyed lacked a plan; and

(g) having an estate plan that incorporates how ownership will be dealt with – **63%** of family businesses surveyed lacked a plan.

2.8 The Report also acknowledges the disconnect between the 'readiness' of a future family head taking over the family business from the incumbent family head, with the current family head often overestimating the future family head's readiness in the short-term, while underestimating the future leader's ability in longer-term transitions.[8]

2.9 What these numbers show is that although family businesses are now more aware of the challenges facing them in relation to their succession plan, there is still much room to assist clients in putting in place appropriate strategies and documents to assist with the transition.

3 Academic literature in relation to family business

3.1 Family businesses offers unique issues not considered as part of non-family businesses.

3.2 There has been a rise in academic literature[9] relating to a concept of 'socioemotional wealth' (or '**SEW**') and its influence in the decisions made by family businesses.[10]

3.3 SEW has been defined as the *'non-financial aspects of the* [business] *that meet the family's affective needs, such as identity, the ability to exercise family influence, and the perpetuation of the family dynasty'*.[11]

[8] Ibid, page 15

[9] However, the literature acknowledges the early nature of such research and theories.

[10] The author has specifically considered the following research and papers in relation to this concept of 'SEW' and the contents of this section 3 is largely influenced by the information read: Gavin J Nicholson, "Succession Planning Management (SPM): A Case Study of Vietnamese Family Owned Business in Australia" Submitted in fulfilment of the requirements for the degree of Doctor of Business Administration (DBA) Victoria University Graduate School of Management College of Business; Matias Kalm and Luis R. Gomez-Mejia, "Socioemotional wealth preservation in family firms" Revista de Administracao 51 (2016) 409-411; Qing Lan, "Understanding Socioemotional Wealth – Examining SEW and Its Effect on Internationalization" May, 2015 as part of a Master's thesis within Business Administration of Jonkoping International Business School; David Devins and Brian Jones, "Review of Family Business Research on Succession Planning in the UK" ERASMUS+ KA2 Strategic Partnership 2014-1-HUO1-KA200-002307 ;Helge Mensching, Sascha Kraus, Ricarda B. Bounchken, "Socioemotional Wealth in Family Firm Research – A Literature Review" JIB, Volume 14, Number 4 2014.

[11] P Berrone, C Cruz, L.R Gomez-Meija, "Socioemotional Wealth in Family Firms: Theoretical Dimensions, Assessment Approaches , and Agenda for Future Research" *Family Business Review,* 25(3), 258-279 – It has been proposed that SEW could be broken down into five preferences (**FIBER**), namely (1) **f**amily control and influence; (2) **i**dentification of family members within the firm; (3) **b**inding social ties; (4) **e**motional attachment; and (5) **r**enewal of family bonds to the firm through dynastic succession

3.4 To put simply, family businesses need to manage the 'family' aspects and issues that come with having family involved in the ownership and management of the business.

3.5 Whilst non-family businesses merely need to balance the relationship between management (those making the day-to-day decisions) and ownership (those who benefit from the growth in the business); family businesses also need to consider the impact decisions at the management and ownership level could have on family standing both internally and to the wider community.

3.6 It has been suggested that '*family* [businesses] *are typically motivated by, and committed to, the preservation of SEW*'.[12] This means that decisions in family businesses are often made to maximise:

(a) a family's control and influence in the business;

(b) the identification of family members involved in the business;

(c) the potential to exert the family's name within social ties and the broader community;

(d) emotional attachment of the family in the business; and

(e) the prolonging of the 'family dynasty',

even (potentially) to the detriment of the business financially.

3.7 Examples of the effect SEW may have on certain business decisions are listed below in comparison to potential decisions that non-family businesses *could* make.

Family business	***Non-family business***
Picking family members into leadership roles in the business regardless of experience as it maximises the identification of family members in the business and family control	Picking a person (whether family or not) with the most suitable qualifications into leadership roles, whether internally (from the business) or externally
Family member executives deciding to proceed with risk adverse strategies to maintain the family wealth[13]	Directors deciding to proceed with strategies to maximise potential returns
Family businesses choosing to self-finance transactions to ensure control is retained within the family	Non-family businesses may seek financing via debt financing or equity participation from non-family members to undertake any large-scale transactions
Family businesses choosing to 'avoid taxes less aggressively than nonfamily' businesses out of fear of the negative outcomes associated with aggressive tax avoidance[14]	Management seeking strategies that can maximise profits to the owners (to validate the appointment of such persons in management positions)

[12] Ibid

[13] Family businesses may alternatively be willing to take large financial risks to mitigate losses on their socioemotional wealth

[14] S. Chen, X. Chen, Q. Cheng and T. Shelvin (2010), "Are family firms more tax aggressive than non-family firms?" *Journal of Financial Economics*, 95(1), 41-61

Family businesses 'sticking by' underperforming family member executives either due to fear of repercussions within the family dynamic or due to the fact that such executive is earning less than what a non-family member executive would have earnt	Non-family member executives more easily criticized and dismissed if underperforming
Lack of written documents and evidence maintained due to the trusting nature of family members	Formal documents and processes implemented to provide a record of decision making

3.8 Additionally, social, economic, political and cultural factors can further impact the decisions and processes in a family business. For example, literature has suggested that Anglo family businesses in Australia tend to excel in business performance and individualism, with moderate business longevity. In contrast, Asian family businesses were found to focus on family and collectivism.[15] It was also acknowledged the superstition against discussing death and finality found in Asian culture resulted in Asian family businesses having a lack of succession planning or focus.

3.9 As may be identified, decisions made by family businesses can often be driven by emotion rather than rational thinking. Therefore, the input of independent advisors cannot be underestimated in ensuring family businesses are advised in a balanced and non-biased manner.

4 Succession planning issues for family businesses

4.1 Given that one of the key influences in how decisions are made in family businesses revolves around the want to create a 'family dynasty', it would be expected that succession planning for family businesses should be high on the list of issues to be properly considered.

4.2 Unfortunately, statistics show a different picture, with the vast majority of family businesses lacking an appropriately documented succession plan.[16]

4.3 The role that independent advisors play extends further than just providing advice but also in assisting families to bypass the initial inertia associated about planning for death or loss capacity, and putting arrangements and documents in place to allow for a suitable transition in creating that family dynasty.

4.4 Once traction to consider the succession plan for the family business is in motion, the crucial questions that need to be asked of the family can be summarised as follows:

(a) *What is the long-term vision of the ownership in the family business? Specifically, who should take ownership of the business after the current family head leaves?*

(b) *How should decisions in relation to the family business be made in the future to ensure the longevity of the family business? Specifically, should there be a framework implemented to require certain people to 'approve' or be in the majority of decisions being made in the family business?*

[15] D. Waddel, M. Parris, J. Ye (2013), "The succession decision in Chinese-Australian family businesses: An exploratory study", *Small Enterprise Research*, vol. 20, p.110-125

[16] See paragraph 2.7 for statistics of various succession or transition issues not properly considered and documented

(c) *Are there any family issues or concerns that can affect the implementation of the above intention?*

4.5 Each of these questions will have various sub-questions and issues to consider, but the broadness of the questions will at least be the start of a continuous ever-evolving discussion with the family.

What is the long-term vision of the ownership in the family business?

4.6 The information sought from this question is to effectively understand who should benefit from the operations of the family business:

(a) once a parent exits the business;

(b) once both parents have exited the business; and

(c) for the next generation or two down the line.

4.7 Families should consider if any of the following outcomes are ones that they are looking to achieve for their family business:

(a) the family business to be managed for the benefit of a surviving spouse;

(b) the family business to be managed for the benefit of a child or children involved in the business, whether that be:

(i) equally; or

(ii) disproportionately;

(c) the family business to be managed for the benefit of the broader family (i.e. all children) despite only having some of the children involved, whether that be:

(i) equally;

(ii) disproportionately; or

(iii) in a manner determined by key family members;

(d) the family business be sold to particular family members at market value (as opposed to being passed down under a succession plan);

(e) the family business be sold to key employees or third parties in the business at market value; or

(f) the family business to be wound up on the family head's exit.

4.8 Where the family business is a 'partnership' between siblings or a combination of family members (each considered a separate **Family Branch**), the questions need to be considered holistically by all Family Branches and whether all other Family Branches are in agreement.

4.9 Further, the traditional business succession planning issues may also need to be considered given separate 'partners' (despite the parties being family) such as:

(a) whether an exiting family member will transfer their share in the family business to the remaining family member/s; and

(b) how such a transfer will be funded (e.g. whether the remaining family member/s must fund third party financing to pay out the exiting family member, whether the use of a buy sell deed is appropriate, or whether the transfer occurs for no consideration given the close family relationship).

Example

A family business operates various sea vessels. The business is owned by two brothers (Adam and Ben) as equal owners (through their family trusts in a partnership).

Both brothers will need to consider what happens to their respective share in the business regarding who takes ownership in the event either one or both of them lose capacity or pass away (**Default Event**).

Adam has three sons involved in the operation of the business, while Ben has one son who is not involved in the business.

Scenario 1

Adam and Ben agree that on a Default Event occurring to Ben, Adam (or Adam's sons) will 'buy-out' Ben.

The 'buy-out' can be way of finding bank financing or through a self-funded insurance buy sell deed.

Scenario 2

The two families enjoy a close relationship and it is agreed that it is in the best interest to keep the two Family Branches involved with each other.

Steps are taken to introduce Ben's son in the business and in a position to succeed Ben on the occurrence of a Default Event.

Documents are also implemented to ensure each family member in the second generation receives an equal share in the business and in a manner that reduces a potential abuse of power by Adam's three sons holding a majority interest in the business.

Informal documents are also prepared to ensure Adam and Ben's respective spouses continue to benefit from the family business in the same manner as if Adam and Ben were in control.

4.10 Further complications can arise when the intention is for certain 'subsidiaries' or business branches/assets to pass to specific family members, especially where the family business is not operated through a suitable structure.

Example

A family business operates various businesses selling tyres and autocare services, effectively creating a brand through the State.

The business is operated through a discretionary trust by the father (Carl).

Carl has three sons who are all involved in the family business.

As Carl is too old to continue managing the business, Carl wishes to step down and pass control of the business to his three sons.

Unfortunately, in this case, Carl's three sons do not get along and as a result various stores must be transferred into separate structures controlled by each of the sons at significant stamp duty and capital gains tax costs.

Comments

This example (which is inspired from the facts of a payroll tax case) is an example of a family business not having an appropriate succession plan in place.

If a succession plan was considered and it was found that the sons would be unable to work together, then the question on how to separate various stores in the business and set them aside for the relevant son would be appreciated and appropriate strategies implemented prior to the transition (even if to just manage the adverse tax consequences).

4.11 Understanding a family's intention in relation to the ownership of the family business allows us as independent advisors to consider:

(a) whether the current succession planning arrangements for the family is sufficient to achieve the family's intention;

(b) whether the current structure of the family business is appropriate to achieve the family's intention; and

(c) what is the best structure to achieve the family's intention for the family business?

4.12 We will discuss further below about the importance of having the right structure in place and how 'beneficial' ownership can pass in those structures from a succession planning perspective.

How should decisions in relation to the family business be made in the future to ensure the longevity of the family business?

4.13 Although it is critical to ensure ownership in the family businesses passes for the benefit of the intended family members, studies have shown that businesses in which the CEO (e.g. the family head) has a specific successor in mind tends to be more successful than other businesses.[17]

4.14 Therefore, the success of a 'family dynasty' will largely rely on those involved with making decisions in the future for the family business

4.15 While this question looks to draw out the current family head's intention and opinion regarding who should succeed as the family head, there are various ancillary issues that should also be considered at this juncture to ensure the transition to the new family head is appropriate and well managed.

4.16 These ancillary issues can include:

(a) who the successor family head will be;

(b) whether the successor family head/s will be one or more people;

(c) whether other persons should be appointed as a director with the family head;

(d) whether there should be qualifications required prior to a person being appointed as a director;

(e) whether key non-family employees or independent advisors should be involved in the decision-making process and appointed as a director;

(f) whether the knowledge of the existing family head has been transferred to the successor (being the successor family head and/or directors) or how such knowledge can be transferred;

(g) whether the successor has been integrated and respected within the business (by employees) and key third parties (such as suppliers);

[17] F. De Visscher (2004), "Balancing capital, liquidity and control", available at http://www.devisscher.com, accessed September 2019

(h) whether the successor's values aligns with the family businesses values;

(i) when the transition to the successor should occur; and

(j) if a framework (whether informal or outlined in a legally binding or non-legally binding document) should be implemented in appointing successors that can survive the first transition of the family business.

4.17 As outlined above, family businesses often choose to appoint family members as 'CEO's of the business. This decision can be made regardless of whether such a family member has the appropriate qualifications or experience to fulfil this role.

4.18 While such a decision may be seen (independently) to be inappropriate, the role as advisors to the family business should be focused on ensuring the chosen successor has the appropriate support systems and processes in place to succeed.

4.19 While this may simply be achieved by having the chosen successor 'shadow' and learn from the current CEO by making direct decisions that can impact the business, it can be extended to having key advisors involved with the decision making (whether it be informal or legally embedded in a document) for the successor.

Example

Dad and mum have operated a food stall off the street for over 30 years.

The food stall was once filled with customers but due to changes in lifestyle, technology and food palates, the customer base has diminished.

As a result, non-family staff have been let go and in order to manage the rising costs of employees, they have reached out to their daughter to assist in the family business.

Despite initial concerns in passing the decision making of the business to their daugther, the fresh perspective of the daughter in utilising technology to be more efficient in the preparation of food (rather than making products by hand) and broadening the customer base (through online social media orders) allowed the family business to be modernised to the needs of the customers.[18]

In this example, the passing of experience came down to just allowing the next generation to make some decisions in the business.

4.20 Understanding a family's intention in relation to who should be responsible for directing the family business allows us as independent advisors to consider:

(a) what can be done today to allow for the transition to be as smooth as possible;

(b) whether arrangements or documents need to be prepared to assist with the transition by establishing support systems and processes; and

(c) whether thought has been considered in relation to putting in place a framework for future generations to work with.

4.21 We will discuss further below the various processes and legally binding documents that can be prepared to assist with such a transition.

Are there any family issues or concerns that can affect the implementation of the above intentions?

[18] Example has been inspired from the stories told in Netflix's TV series "Street Food" (2019), SeaSon, Episodes relating to Chiayi, Taiwan; and Singapore

4.22 Existing studies have already outlined how 'the family factor' can influence the decisions of a family business in unexpected manners. It is therefore crucial to properly understand the 'family factor' relating to each family business as no two families will be the same.

4.23 Given the personal nature of family dealings, questions and issues that are often considered as part of a personal estate plan will also be relevant for the succession plan of a family business.

4.24 These questions and issues can include:

(a) family members having an issue with the business succession plan, which can arise:

(i) when a family member working in the business is left with less than what they expected;

(ii) where a promise was made to a family member to receive more of the family business than was received;

(iii) where certain family members are passed up from leadership or directorship roles in favour of other family members;

(iv) due to 'rivalry' issues between family members; or

(v) due to some family members feeling like they do more in the business than others (and they have accordingly not been appropriately acknowleged or appreciated);

(b) concern of certain 'step-family' or children-in-laws negatively affecting the direction and performance of the business;

(c) whether separate Family Branches are able to work with each other for the family as a whole;

(d) issues in being direct with failings within key family members;

(e) a lack of clear communication lines (or 'workability') between the family members involved in the family business (those in 'Management') and those reaping the benefit (the 'Owners');

(f) 'buried' family arguments arising once the older generation has left the picture;

(g) the asymmetrical influence, power and views between generations which can result in:

(i) older generations choosing not to transition day-to-day decision making to younger generations at the right juncture;

(ii) older generations not valuing or considering opinions from younger generations; or

(iii) younger generations keeping with the 'status quo'; and

(h) the lack of the family retaining appropriate documentation of key decisions and resolutions; and

(i) failing to enforce an underlying family value that can outlast the generation.

4.25 Potential family issues in a family business succession plan based on real life examples (which are further considered in the Annexure) can include:

(a) the father who had to protect the succession of the property management business he built for the benefit of his daughter, whilst in the middle of a matrimonial breakdown;

(b) the father and mother who needed to pass down the business to their three children with various issues between each child:

(i) one child took a lead role in the business and believed he deserved more from the business;

(ii) one child and her husband was involved in the business, but they were often considered as underperforming; and

(iii) one child who had nothing to do with the business (and thereby managing the sibling's feelings); and

(c) the father who had concerns that his eldest daughter and son-in-law would cause trouble in the family business until it was sold, and ensuring the right children of his took control of the business to build that 'family dynasty'.

4.26 What needs to be appreciated is that 'the family factors' and issues will continuously evolve as:

(a) family members who may have no involvement in the business may choose to start working in the business;

(b) estranged relationships can reconcile;

(c) existing relationships can sour due to disagreements; and

(d) family values and standings can change,

and as a result, a family business' succession planning must consistently be reviewed (even more than a business operated between non-family members).

5 Ownership of the family business

Business entities and succession planning

5.1 Having the right structure in place in which a family business operates from is crucial in ensuring ownership in the family business passes as intended.

5.2 Unfortunately, very few family businesses are established with creating a 'family dynasty' in mind and as a result, it is common for business entities to require restructuring.[19]

5.3 Before considering how business entities can be restructured into appropriate structures, it is useful to appreciate the succession planning issues related to common business structures.

5.4 The most common entities used as part of family businesses are listed as follows:

(a) company (whether with individual or trust shareholders);

(b) discretionary trust (whether with individual trustees, company trustee and/or an appointor role).

[19] Restructuring can also be necessary for various non-succession planning factors such as tax planning, financing and/or asset protection

5.5 It is also useful to acknowledge the distinction in the above structures between ownership (who the underlying owners are), and control (those who will manage the business and with the strategies and documents of which will be considered in a separate section).

Company considerations

5.6 The use of a company as the family business vehicle is not an uncommon one.

5.7 The benefits of having a flat reduced tax rate and the ability to retain earnings within the business environment are often stated as reasons for establishing a company to operate a business.

5.8 The two key roles involved with a company are the:

(a) members (or shareholders who are the legal entities that own the shares and ownership interest in the company equal to the proportion of shares they own); and

(b) directors (being the people who are responsible for making the legal decisions for the company).

5.9 From a succession planning perspective, the:

(a) management of the company can be dealt by putting in place appropriate processes and documents governing the succession of the director – for instance, pursuant to a shareholders agreement or a tailored company constitution; and

(b) ownership of the company is managed through ensuring the shares in the company pass to the right people – for instance through the use of call option agreement or transfers during the lifetime of key persons.

5.10 This means that ownership in the company will be passed according to a family's intention by having the shares go to the intended family members.

5.11 Where the shares are held by individuals, that individual will require an appropriate Will to specifically ensure the shares are gifted to the relevant family members. The Will could be prepared to specifically gift the shares directly to the recipient or indirectly to the recipient by a testamentary trust.

5.12 Where the shares are held by trustees for a trusts, then the terms of the trust will need to be reviewed and documents prepared to ensure control of that trust passes to the relevant family members.

5.13 If the shares are held by other companies, then the succession planning considerations above will need to be made in relation to that holding company.

5.14 Complications can arise with shares held by individuals where it is likely that an individual's Will could be challenged. Potential arguments in having an individual's Will challenge can arise:

(a) where a disgruntled family member believes they have not their fair share under a Will (which is common in blended family situations between children from a prior relationship and a current spouse);

(b) where certain promises were made to family members that the family business would pass to them, and such promises were not followed through in the documentation; or

(c) where it can be argued that a deceased failed to have adequate mental capacity in making their Will.

5.15 In situations where there is a chance of a Will challenge, steps should be taken to mitigate the likelihood of disruption with the business transition. Some available solutions can be restructuring the shareholding during the lifetime of the individual such that the shares do not pass into an individual's Will (i.e. by transferring the shares into a trust), or implementing arrangements such as 'gift and loan back arrangements' to deter persons from challenging an estate.

5.16 In addition to succession planning considerations, thought may be made to transfer shares held by individuals to a more appropriate entity due to tax or bankruptcy concerns. Specifically:

(a) having an individual hold shares in a trading company reduces the flexibility in distributing franked dividends within the family; and/or

(b) having key individuals or risky individuals (for example, directors of a trading company) holding shares is not optimal should such individual be sued in their personal name.

Discretionary trust

5.17 Although not always typically associated as the 'go-to' structure for operating businesses (largely due to the fact that all profits made in a year must be distributed out of the trust to beneficiaries as accumulation of such profits results in the top marginal tax rate applying), discretionary trusts can be more commonly found in family businesses.

5.18 Often dubbed 'family trusts', the flexible nature in being able to distribute profits between a group of family member beneficiaries and changing such distribution pattern each year can be seen as advantages in themselves. This is possible due to the nature of what a trust is, and the mechanisms of a discretionary trust.

5.19 Broadly, a trust is a legal relationship where there is:

a a legal owner of property (the '**Trustee**'), who;

b holds the property ('trust property');

c for the benefit of others (the '**Beneficiaries**'); and

pursuant to certain terms or rules ('trust deed').

5.20 Unlike companies and sole traders, a trust is not a separate legal entity. Instead, the Trustee looks after the property and manages the trust (i.e. the management position). Any benefits generated from the trustee's management can then be given to the Beneficiaries (i.e. the owners).

5.21 The complexity that a discretionary trust adds to ownership is the fact that there is a broad ***discretion*** of the Trustee to decide who can benefit from the trust.

5.22 Whilst other trusts may fix who can benefit (and thereby there can be a clear ownership percentage), a discretionary trust blurs this ownership percentage by allowing the Trustee to decide (at the Trustee's discretion) who can benefit from the trust, whilst being able to change this discretion on a yearly basis.

5.23 The 'owners' (i.e. the Beneficiaries) of a discretionary trust are therefore more reliant on the decision-making of the Trustee and absent any other role, are often named or involved at the Trustee level.

5.24 That other role referred relates to a role who can have the ability to change the Trustee. This role is often called the 'appointor' or 'principal' role (**Appointor**), and can even go by other terms.

5.25 A benefit of such a role is that the underlying owners of a discretionary trust can exert a form of influence over the Trustee to make decisions in the best interest of the owners, else they be replaced with someone more complying.

5.26 It is noted, however, that not all discretionary trusts hold an Appointor role.

5.27 Although it is common for family businesses to align all the roles (Trustee, main Beneficiaries and Appointor role) together, the flexibility of having these separate roles become more apparent when undertaking a succession plan for the trust.

5.28 Practically, from a succession planning perspective for a discretionary trust, it is crucial to understand who takes over the Trustee and/or Appointor role.

5.29 Generally, the trust deed will outline a default position on who takes control on the passing of individuals in those roles as well as provide general powers allowing for successors to be nominated. However, each trust deed must be reviewed to confirm this position as each trust deed providers draft their documents differently.

5.30 Issues that must be considered in the trust deed relating to the succession of the trust include, whether the trust deed:

(a) states who takes control of the relevant role in default of any specified nomination;

(b) provides a power to the Trustee or Appointor in nominating a successor (and if the power can be made by Will);

(c) imposes restrictions on who can be a successor (including if there are limits on the number of nominations);

(d) can be amended to include broad powers if the terms are considered too limited.

5.31 Where companies are involved in these roles, then relevant company documents (such as constitutions) must be considered in addition to the terms of the trust deed.

5.32 More curious questions include:

(a) whether an individual or company should be appointed into the Trustee and/or Appointor role as part of the transition strategy today rather than in the future; and

(b) whether steps can be taken to maximise the trust's vesting date, or potentially extending it indefinitely under South Australian trust law.

The importance of the right structure

5.33 To highlight the importance of having an appropriate business structure as part of a family business succession plan, consider the following example:

(a) Dad and Mum has operated a family owned bakery business for the past 20 years.

(b) The business has grown to have stores in four suburbs across Brisbane held in various companies and a family trust (see the diagram below).

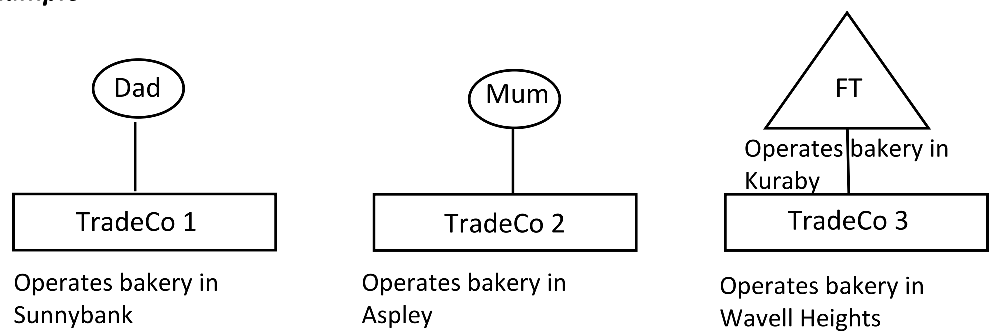
(c) Over the past 7 years, Son and Daughter have been involved in managing the various locations for Dad and Mum.

(d) Dad and Mum are looking to take a step back in the business and allow Son and Daughter to take ownership in the business.

(e) Specifically, Son is to own the bakeries located in Sunnybank and Kuraby, whilst Daughter is to own the bakeries at Aspley and Wavell Heights.

(f) Is it possible to achieve Dad and Mum's intention?

Example



5.34 While it could be possible to achieve Dad and Mum's intention (without adverse tax[20] or stamp duty consequences) with appropriate Wills and trust succession documents, these documents would only be of effective on the death of either or both of Dad and Mum due to various tax exemptions available on death.

5.35 To effect Dad and Mum's intention while they are still living will be more complex as the structures currently do not allow (easily) for ownership to pass to Son and Daughter in the manner as Dad and Mum intended. Specifically:

Sunnybank bakery and Aspley backery

(a) TradeCo 1, which holds the bakery in Sunnybank, is intended to pass to Son;

(b) the shares in TradeCo 1 are held by Dad;

(c) the only way to pass ownership in TradeCo 1 from Dad to Son would be to transfer the shares;

(d) the transfer of the shares will trigger a capital gains tax event,[21] requiring Dad to pay tax on the increase of the value of shares since the incorporation of Trade Co 1;

(e) TradeCo 2 holds the bakery in Aspley that is intended to pass to Daughter;

(f) the shares in TradeCo 2 are held by Mum;

(g) the same comments in relation to the capital gains tax issues for TradeCo 1 will apply for TradeCo 2 (with Dad and Son replaced with Mum and Daughter);

Kuraby bakery and Wavell Heights bakery

(h) a discretionary trust operates the bakery in Kuraby (which is intended to pass to Son);

[20] Subject to TD2018/3 applying to any 'trust splitting' arrangements implemented for 'FT'

[21] The applicable capital gains tax event would be 'CGT event A1' per section 104-10 *Income Tax Assessment Act 1997*, and a capital gain would still be recognised even if the transfer occurred for no consideration as section 116-30 *Income Tax Assessment Act 1997* (Cth) provides a market value substitution rule in relation to CGT events occurring for less than market value consideration

(i) as mentioned above, the underlying people who can benefit from a discretionary trust are the beneficiaries;

(j) the important role in deciding, however, who can benefit from the discretionary trust lies with the trustee;

(k) to therefore provide Son with 'effective ownership' (by being able to dictate who benefits from the trust),[22] the trustee role in the discretionary trust will need to pass to Son;

(l) this can be effected by way of a change of trustee of the discretionary trust to Son directly (or indirectly through a separate individual or company);[23]

(m) TradeCo 3 operates the Wavell Heights business which is intended to pass to Daughter;

(n) the shares in TradeCo 3 are currently held by the discretionary trust operating the Kuraby bakery;

(o) there will be complications to ensure the ownership in TradeCo 3 passes to Daughter, as it cannot be done by way of allowing Daughter to take control of the shareholding trust (as it is intended that Son take control of that trust);

(p) instead, the shares in TradeCo 3 would need to be transferred to Daughter and the same capital gains tax consequences in relation to TradeCo 1 and TradeCo 2 will be applicable.

5.36 As can be seen from the high-level summary, the current structure of the family business is not appropriate to achieve the family business' succession plan.

Restructuring the business to align with the succession planning intentions relating to ownership

5.37 Where it has been determined that the entity the business operates from requires restructuring, thought must be taken in relation to (at a minimum) the following factors:

(a) the tax implications, namely:

(i) income tax/capital gains tax;

(ii) stamp duty; and

(iii) goods and services tax;

as well as other tax factors such as:

(iv) any effect on the cost base of assets; and

(v) managing existing loans and interest repayments;

(b) the commercial implications and impact of time spent contacting key clients, suppliers and financiers in relation to the impact the restructure may have on any existing contracts; and

(c) the cost of engaging professionals such as specialist tax advisors and lawyers.

[22] Son would also need to check the terms of the trust deed in relation to the range of the beneficiaries and decide if the beneficiary class is appropriate

[23] There are various change of trustee exemptions available both at a capital gains tax level (see the notes in the various 'E' events in *Income Tax Assessment Act 1997* and section 117 *Duties Act 2001* (Qld)

5.38 Other sessions will consider various restructuring strategies available without incurring adverse tax consequences, so this paper will merely provide an overview of *some* of the available rollover, concessions and exemptions.

5.39 In deciding what strategy should be used, the preferred structure for the family business to operate should be settled. This includes confirming if there should be separate 'sub-branches' of the business (either holding separate business assets or business locations).

5.40 Potential rollovers, concessions and exemptions available for use include (but are not limited to):

(a) in relation to moving business assets without adverse income tax/capital gains tax consequences:

(i) transferring an asset from an individual or trustee of a trust to a company (with the shares held by the transferor)[24] – this can be useful when it is determined that a business is better suited to being operated from a company rather than a sole trader or a trust;

(ii) transferring an asset held by partners in a partnership to a company (with the shares held by the partners accordingly)[25] – this could be relevant when the business is conducted by multiple family members in a partnership, and it is determined that it would be better suited to be operated from a company;

(iii) transferring an asset held by a 'unit' trust to a company (with the shares in the company held by the unitholders of the 'unit' trust)[26] – again, this can be useful when it is determined that a business is better suited to being operated from a company rather than an unit trust;

(iv) utilising the small business restructure rollover to move a business from one structure to another[27] – this option is available when there are no existing rollovers available to move the business into the desired structure (for example transferring the business from a company to a discretionary trust);

(v) utilising the small business capital gains tax concessions to move business assets from one structure to another[28] – this option is available regardless of the structure but is only limited to 'small businesses';

(vi) splitting a business under the demerger rules;[29] and

(vii) forming a tax consolidated group and transferring assets within the group;[30] and

(b) in relation to moving business assets without adverse Queensland stamp duty consequences:

(i) transferring business assets from one company to another company in the same 'group'[31] – this is useful if trying to segregate business assets or sub-

[24] Subdivision 122-A *Income Tax Assessment Act 1997* (Cth)
[25] Subdivision 122-B *Income Tax Assessment Act 1997* (Cth)
[26] Subdivision 124-N *Income Tax Assessment Act 1997* (Cth)
[27] Subdivision 328-G *Income Tax Assessment Act 1997* (Cth)
[28] Division 152 *Income Tax Assessment Act 1997* (Cth)
[29] Division 125 *Income Tax Assessment Act 1997* (Cth)
[30] Part 3-90 *Income Tax Assessment Act 1997* (Cth)
[31] Chapter 1 Part 1 *Duties Act 2001* (Qld)

businesses and appointing different family members in the management roles of the respective company (albeit, there may still be issues in separating the ownership);

(ii) transferring assets between trusts through trust cloning – this may be useful in trying to segregate business assets where the transfer occurs between trusts as opposed to 'group' companies;

(iii) transferring certain business assets to other entities[32] – this is another way to segregate certain business assets, specifically intellectual or personal property, away from the trading risk of a business;

(iv) changing the trustee of a trust conducting a business to a company[33] – this is useful where a discretionary trust is considered to be the most appropriate structure and the use of a company trustee enables suitable transition in the succession of the trust; and

(v) changing 'default' beneficiaries in a trust to certain family members[34] - this may be desirable when incoming family members would like to change key beneficiary roles in the discretionary trust.

5.41 When employing a strategy, specialist tax advice must be sought to ensure all the appropriate requirements are met. Such advice will also 'marry' the various tax considerations that intertwine when undertaking a restructure, including GST factors.

5.42 Once the family business is operating from the most suitable structure, steps can be taken to put in place appropriate documentation to ensure ownership of such structures pass in a manner consistent with the family's intention.

Documentation required to align the ownership with the succession planning intentions of the family

Passing ownership in a company

5.43 As outlined above, ownership in a company rests with the members of the company.

5.44 In the circumstances of a company limited by shares, this means the shareholders are the owners.

5.45 The issue, therefore, is ensuring that shares in the company operating the family business, passes in a consistent manner with the family's intention.

5.46 In the event of putting in place appropriate documentation passing ownership:

(a) on the death of the current owner (or key person):

(i) where the shares are held by an individual, this means ensuring the current shareholder's Will is drafted in a manner that makes the shares (whether by way of a specific gift, or due to the overall structure of the beneficiaries under the Will) pass to the intended family members who will take ownership of the family business. Where it is not appropriate to have the shares pass via an individual's Will (due to a potential estate challenge as mentioned above), documents such as a shareholders agreement or call

[32] Section 37 *Duties Act 2001* (Qld)
[33] Section 117 *Duties Act 2001* (Qld)
[34] Section 118 *Duties Act 2001* (Qld)

option agreement may be suitable in providing certainty for successor family members to obtain the relevant shares on the death of the individual;

(ii) where the shares are held by a trust, this means reviewing the succession of the trust on death and ensuring control and/or ownership in the trust passes to the intended family member. The succession of control and ownership in a discretionary trust will be discussed further below;

(b) on the loss of capacity of the current owner (or key person):

(i) where the shares are held by an individual, this means ensuring an appropriate enduring power of attorney document is prepared to allow the intended family members to make decisions on behalf of the current owner, as shareholder of the company (please note that the ability to make director decisions are not usually transferrable under an enduring power of attorney document);

(ii) where the shares are held by a trust, this means reviewing the succession of the trust on loss of capacity of the key person and ensuring control and/or ownership in the trust passes to the intended family member;

(c) during the lifetime of the current owner (or key person):

(i) shares (whether all or only a proportion) in the company can be transferred to the intended family members, with the current owner (or key person) retaining some proportion of shares;

(ii) call options over shares (whether all or only a proportion) in the company could be granted to the intended family members, with certain conditions precedents being met prior to such options being able to be exercised; or

(iii) where the shares are held by a trust, control in the trust can be diluted between the current key person and intended successor family members.

Passing ownership in a discretionary trust

5.47 As outlined above (at paragraph 5.28), practical ownership in a discretionary trust passes through the Trustee, and in the event there is an Appointor role in the trust, the Appointor.

5.48 This is notwithstanding the fact that the ultimate benefactors of the discretionary trust are the beneficiaries (as it is the Trustee of the discretionary trust who is able to decide which beneficiaries may benefit from the trust).

5.49 Appropriate documentation will therefore need to be put in place to ensure the underlying owner's control and therefore benefit from the discretionary trust pass as intended:

(a) in the circumstances where there is no Appointor role:

(i) a deed of change of trustee can be prepared to change or dilute the Trustee role while the current owner is involved in the business. This can either by way of appointing multiple individual trustees or appointing a company trustee with multiple directors. This can allow the intended family member to take control of the discretionary trust immediately on their own or jointly with the current owner; or

(ii) a deed of appointment of successor trustee can be prepared to automatically change the trustee on certain events occurring to the current trustee (such as death or loss of capacity). This document is usually prepared when a current owner is the individual trustee and wishes to continue having control in the family business until they lose their ability to make those decisions (such as on death or loss of capacity);

(b) in the circumstances where there is an Appointor role, much of the same documents mentioned above can be prepared specifically for those involved at the Appointor level. There will, however, be more flexibility when there is an Appointor role, as separate persons can be appointed into the Trustee and Appointor role (for example, the management of the discretionary trust can pass to the intended successor family head by way of the change of trustee, while the current family head can separately step into the Appointor role).

5.50 In the event when the trust already has a company as Trustee or Appointor, steps could just be taken to change the directorship and shareholding in that company accordingly.

Other factors

5.51 Where there are various structures in the family business, each structure and relevant role will need to be carefully reviewed and documentation prepared.

5.52 It may be that ownership of certain entities in the family business pass to certain family members with the other entities in the family business passing to the remaining family members.

> ***Example***
>
> A company operates a business selling spare vehicle parts.
>
> The company operates the business in a commercial warehouse owned by a related discretionary trust.
>
> Mum and dad have two children (Jason and Jane) who are involved in the business.
>
> It is mum and dad's intention that each child gets an equal share in the business. However, given that Jane is going to inherit a residential property under mum and dad's Will, it is their intention to pass the commercial warehouse (in which the business operates from) to Jason.
>
> Mum and dad will need to ensure the shares in the company pass equally to Jason and Jane, and have control in the discretionary trust pass to Jason through a separate set of legal documents.

5.53 Separately, where there is a unit trust involved within the business structure, the succession planning issues considered for both companies and discretionary trusts will need to be considered as the underlying owners in a unit trust (in contrast to a discretionary trust) can be clearly identified through the unitholders (much like the shareholders in a company).

5.54 Thought should also be made in relation to any loans and/or unpaid present entitlements (**UPEs**) within the family group, and whether any existing loans/UPEs inadvertently shifts value away from intended persons (for example, the trading entity owing a large sum to the key individual of the business whereby certain children will take control of the trading entity, but all children will benefit equally under the key individual's Will).

5.55 Any succession planning documents implemented will, of course, need to be consistently reviewed and updated accordingly considering any changes with family dynamics.

6 Decision-making in the family business

6.1 A successful family business succession plan requires more than just ensuring ownership in the business passes to intended family members.

6.2 Without anything further guidance, nothing stops ill-informed family members with ownership interests from operating the business into the ground.

6.3 In other words, thought and consideration should be made in appointing appropriate persons into director roles in the family business.[35] In addition, a framework should also be put in place dictating who may be appointed into director positions further down the track and how such persons will be appointed into such capacity.

Transitioning today or tomorrow

6.4 An often-difficult task for family heads is to consider when to pass the decision-making in the family business down to the next generation. Current family heads may feel that they can keep going running the business through themselves or may just not be comfortable relinquishing control at this stage.

6.5 What may not be appreciated, however, is the longer a family head chooses not to pass key decision-making responsibility down to their successor, the more likely the successor may feel ill-prepared to take on the family head or director (a decision-maker) role.[36]

6.6 It is imperative that steps are taken to integrate key future decision-makers into the business today, rather than tomorrow.

6.7 Doing so allows decision-making successors to learn and understand the operations of the family business, whilst having the 'safety net' of the knowledge and experience of the current family head.

6.8 Integrating the next generation now also allows them to contribute with potential improvements to the business process and system, based on their education and experiences.

6.9 Where it is not possible to integrate the future decision-makers into the business today, thought has to be given into implementing a transition plan that can allow an as smooth as possible hand-down at a later date.

6.10 For example, whereas an integrated decision-maker would have an opportunity to understand the family business through liaising with staff and key employees, a decision-maker thrown into the 'head' role would be left without any operational experience or understanding on how the business operates.

6.11 A potential strategy to manage this 'void' of understanding in the family business could be to establish a family council (whether formally or informally) in the business with key senior employees or family advisors (with an understanding of the business) to assist and advise the incoming successor/s.

Putting in place a framework

6.12 Whilst establishing the council informally may include nothing more than just verbally informing of the intention to the persons to be involved, setting out such intentions formally can include:

(a) having documents (such as family constitutions, company constitutions and/or shareholders agreements) drafted outlining:

[35] Studies have shown that a common trait of inadequate succession plans include founding fathers retiring without an appropriate successor considered – Rothwell, W.J., (2010), "Effective Succession Planning: Ensuring leadership Continuity and Building Talent from Within", American Management Association (AMACON), NY
[36] See paragraph 2.8

(i) any named successor decision-makers;

(ii) the process to appoint successor decisions-makers;

(iii) any key persons to be involved in advising successor decision-makers, including:

(A) key employees involved in the business – who can assist with advising on the operational aspects of the family business;

(B) independent advisors – who can provide unbiased recommendations in the interest of the family business;

(iv) the process on how decisions must be made including:

(A) the voting power of decision-makers;

(B) any threshold percentage for decisions to be made;

(C) requiring certain persons to be in the majority for decisions or holding casting votes;

(D) limiting the ability for owners to override the decisions of the decision-makers;

(b) implementing additional documents to ensure the above framework cannot be overridden – for example, by ensuring any Appointor role in a trust is structured in a manner consistent with any trustee role which can include:

(i) amending the terms of the trust deed by replacing the Appointor terms; and/or

(ii) changing the Appointor role to align with the Trustee role including through the use of a company appointor (whether the company is the same company acting as Trustee or a new company with the same constitution terms).

6.13 The case studies in the Annexure will outline the different variations on the framework that can be implemented, but are all ultimately formed on the question – "*how should decisions in relation to the family business be made in the future to ensure the longevity of the family business?*"

7 The family factor

7.1 As identified above, appreciating the 'family' factor cannot be underestimated in considering the success of a family business succession plan.

7.2 Without adequate consideration, historical issues or future potential divisions may go unnoticed. For example:

(a) past disagreements between family members may arise and cause division at the ownership or management levels of the family business;

(b) family members may also be unhappy with:

(i) any difference between ownership in the family business with other family members;

(ii) having to provide a continued income stream to the retired heads of the family;

(iii) not being involved with the management of the family business;

(iv) being involved with the management of the family business, but only having an equal share in the ownership (i.e. '*why should I grow the business if I do not receive proportionately more from my efforts?*');

(c) family members may also disagree with the strategic direction the family business is heading, which can be due to various factors such as:

(i) aligning the family business with certain people in a manner that does not reflect the family values;

(ii) shifting the general operations of the business in a manner that does not reflect the family values; and

(iii) an unbalanced shift in the management of the business within family sub-groups.

7.3 It is, however, impossible for current family heads to predict or foresee all the potential fallouts that may occur within the family, so rather than attempting to cater to the potential scenarios, a framework can be put in place within the family.

7.4 This 'framework', known as a 'family constitution' (if in writing) or a 'family council' (if relayed through a group of family members), can be developed to provide a mechanism in allowing family members to assess the conduct of those members in the management of the family business against the overarching values that the family should uphold.

7.5 Although there is no standard framework, such arrangements can often include the following:

(a) a general statement reflecting the vision and values of the family (often decided by the current family heads);

(b) an overview on the intentions and recommendations of the current family heads in the direction of where they would like the family business to go;

(c) an overview on how the current family heads foresee the family unit working together in maintaining and growing the family business;

(d) a list of values that the family unit should strive to achieve and pass down for future generations;

(e) information about how and when non-management family members can review the financial position of the family business, and express their opinions and view to those family members involved at management level; and

(f) how family members can resolve disputes (whether using independent advisors or mediation) and confidentiality concerns.

7.6 While it may be tempting to have the above framework undocumented and left as an unspoken rule within the family, the documenting and commitment to be bound by such document between all relevant family members will go a long way in reducing potential disputes later.

8 Bringing it all together

8.1 A successful family business succession plan will come down to balancing:

(a) the wants of the owners of the business (the ownership);

(b) with whose making the decisions of the business (the management); and

(c) ensuring the decisions are made in a manner consistent with the family (the family).

8.2 This balance can be achieved by properly understanding the goals of all stakeholders and ensuring appropriate strategies and arrangements are implemented through the preparation of various legally and non-legally binding documents.

8.3 Below are some steps that can be taken to implement an appropriate succession plan for family businesses:

(a) **step 1** – have discussions with key stakeholders, namely the heads of the family and key members involved with the business, to understand:

(i) the family's objectives in relation to the succession of the ownership and control in the business;

(ii) the family's values and overriding principles that should be considered for future generations;

(iii) whether there are any transition arrangements that can be implemented to ease key persons into the business;

(b) **step 2** – check whether the current structure of the business is appropriate to ensure the family's intention in relation to the succession of the ownership is able to be effected and if not, undertake a restructure to ensure the business is in an appropriate structure;

(c) **step 3** – put in place appropriate legal documents to ensure ownership in the business passes to appropriate family members (whether by way of Will, deed of change of trustees/appointors and call options etc.);

(d) **step 4** – put in place appropriate documentation that implements a framework in how management in the business passes (in a way consistent with the family's objectives); and

(e) **step 5** – put in place appropriate documentation documenting the family's values as well as discussion and dispute mechanisms to allow non-business family members to discuss issues and transactions with those family members involved in the business.

8.4 For a practical example on how these steps can be applied, consider the case studies set out in the Annexure.

8.5 Examples of questions that can be asked to identify what will be required from a client are provided below:[37]

(a) Who is intended to hold the 'shares' in the family business?

(b) Do the intended recipients want to be the future owners of the business, and if so, how can they be prepared for taking over?

(c) Who are to be the leaders of the business in the future? Are any qualifications required to be met and could this lead to a dispute?

(d) Should steps be implemented to ensure future leaders are brought up to speed, including having 'next-generation' goals put in place, meetings, mentors and education programs?

[37] Questions have been inspired by various articles discussing the succession of a family business in STEP Journal, October 2019, Volume 27/Issue 8, specifically by R Chamberlayne of Wiggin Osborne Fullerlove (2019), "Change at the top"

(e) What is the family's expectation on distributions of the family business assets or income? Will this cause a division?

(f) Is there a policy in relation to non-bloodline family such as spouses and whether they are allowed to have ownership or decision-making roles in the family business?

(g) Is there a policy to dictate or encourage family members to enter into binding financial agreements to protect the value of the family business?

(h) Does the board complement the succession of ownership in the business?

(i) What does the family agree on, and what would they disagree on? How can any conflicts or disputes be managed?

(j) Is it likely that the family will fracture, or continue to operate even if certain family members are not involved in the business?

(k) Does the board or directors know the vision of the founder, and if so, is such vision written down?

(l) Will there be conflicts of interest with key decision makers?

(m) Are there documentation in place to outline the future goals of the business?

(n) Will the board have sufficient independence and able to act in the best interest of the family?

(o) Are board appointments to be made against an objective qualification criteria?

(p) How often will the board meet to discharge their duties effectively, and can they engage independent professionals at the company's expense when appropriate?

(q) Are there term limits for the board members, and will there be written contracts in place?

9 Conclusion

9.1 There is no single correct answer on the best business succession plan for family businesses as every family group has different objectives, intentions and values.

9.2 What is important, however, is understanding the 'family' factor and ensuring appropriate arrangements are put in place to enable 'ownership' and 'management' to work in tandem for the 'family'.

10 Acknowledgement

10.1 The author acknowledges the assistance of Patrick Ellwood, Director of Clover Law in providing feedback for this paper but notes any errors and opinions are the author's own.

11 Disclaimer

11.1 This paper covers legal and technical issues in a general way. It is not designed to express opinions on specific cases. It is intended for information purposes only and should not be regarded as legal advice. Further advice should be obtained before taking action on any issue dealt with in this paper.

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Annexure 1 – Case studies

Example 1

Background

1 Jerry Sanchez, aged 60, operates a business acquiring and managing various commercial property portfolios across Australia.

2 Jerry has a son from his first marriage, Morty, who works in the business as legal counsel and is involved with the property law advice in managing the various commercial properties.

3 Jerry operates his business from a discretionary trust, the Sanchez Investment Trust, as follows:

a each commercial property is acquired through a unit trust structure in which the Sanchez Investment Trust holds a controlling stake in each unit trust;

b the trustee for the Sanchez Investment Trust is a company, Sanchez Investments Pty Ltd with Jerry as the sole director and shareholder;

c the appointor for the Sanchez Investment Trust is Jerry (meaning he can change the trustee at his discretion), with the terms of the Sanchez Family Trust stating that Jerry's legal personal representative will replace him on death or loss of capacity.

4 Jerry has two senior employees who assists with largely with the day-to-day running of the business namely:

a Rick – who acts as CFO; and

b Summer – who is an agent dealing with various sellers across the country.

5 Jerry also has a second wife, Beth Smith, who he intends to leave her the bulk of his personal assets (comprising of a large superannuation member balance and various investment properties).

Step 1 – have discussions with key stakeholders to understand their business succession planning intentions

6 It is Jerry's intention that Morty take control of the family business on Jerry's death or loss of capacity.

7 Despite Morty's involved from the legal side of the business, he still lacks the experience in relation to dealing with current and prospective investors as well as the day-to-day management of various divisions within the business.

8 Jerry decides that Rick, Summer and Jerry's accountant (John) should be involved in assisting Morty in making the right business decisions after Jerry's death or loss of capacity.

9 To reduce any dispute that Beth may have in relation to the Sanchez Family Trust (from a family provision application perspective), Jerry has agreed to give the entirety of his estate to Beth and arrange for any superannuation and life insurance to be paid to his estate.

Step 2 – **check whether the current structure of the business is appropriate to achieve the intentions**

10 Given that Jerry wishes to pass the entirety of his business to Morty, having the business operating from a discretionary trust is perfectly suitable from a succession planning perspective.

11 If the benefits of conducting the business through a company outweighed the disadvantages of restructuring and running the business through a discretionary trust, then steps could be taken to transfer the business into a company structure (with the discretionary trust as the sole shareholder).

12 The adverse stamp duty consequences, however, in this situation were considered prohibitive to such a restructure.

Step 3 – put in place appropriate legal documents to ensure ownership in the business passes to appropriate family members

13 As the business is operated through a discretionary trust, it is important to ensure the role in the Sanchez Investment Trust with the power to change the trustee (in this case, the appointor role), passes to Morty.

14 Given that the current terms of the trust deed states that on death or loss of capacity, Jerry's legal personal representative will fulfil this appointor role, documents must be prepared to match Jerry's intention.

15 This can either be done by:

a appointing Morty as Jerry's legal personal representative under Jerry's Will (and enduring power of attorney) and having the Will beneficiary be Beth; or

b amending the terms of the Sanchez Investment Trust to hardwire the change of appointor role to Morty.

16 Either options can be done without incurring adverse tax or stamp duty consequences, however, the trust amendment approach may be preferred as it reduces the likelihood that a family provision application (a challenge against Jerry's Will) will impact on any transition in the Sanchez Investment Trust.

Step 4 – put in place appropriate documentation that implements a framework in how management in the business should pass

17 As Jerry would like certain key persons to be involved in Morty's decision-making process, a company constitution could be prepared stating that on the death or loss of capacity of Jerry, the following persons would be appointed as a director of Sanchez Investment Pty Ltd:

a Morty; and

b three 'Independent Directors'.

18 The 'Independent Directors' could be defined to initially mean Rick, Summer and John. Where one or more Independent Directors are unable to act, then persons could be appointed to replace those unable to act.

19 Requirements outlining minimum threshold of experience and education could also be listed for any successor Independent Directors.

20 Decisions at this level could be hardwired to require Morty to be in any simple majority to be passed.

21 There is, however, a concern relating to the fact that the appointor role in the Sanchez Investment Trust could pass to Morty without any oversight. This means Morty could be able to change the entity acting as trustee for the Sanchez Investment Trust, thereby overriding the above rules.

22 Steps would therefore need to be taken to either ensure:

a Sanchez Investment Pty Ltd is appointed as the appointor;

b a company with the same constitution as Sanchez Investment Pty Ltd is appointed as the appointor; or

c the appointor role be abolished and any change of trustee powers be transferred to Sanchez Investment Pty Ltd, as trustee for the Sanchez Investment Trust.

23 This would prevent any ability for Morty to bypass the need to liaise with 'Independent Directors'.

Step 5 – put in place appropriate documentation documenting the family's values

24 Given that there are no other family members involved with the family business, no additional documentation will be required.

25 Jerry may, however, choose to outline his intentions for the business to Morty in a separate document as a form of guidance.

Example 2

Background

1 Peter and Lois Griffin (in their 70s), operates a small business importing various vehicle spare parts from overseas for wholesale and retail sales.

2 They have three children;

a Chris (38), who is married with children and heavily involved in the family business;

b Meg (35) who is married and assists with the administrative work in the family business; and

c Stewie (33) who is single and wants nothing to do with the family business.

3 Meg's husband, Morgan, is also involved in the business, in an administrative role. Morgan is known to Chris as often believing he deserves more from the business than the actual work he puts in.

4 Peter and Lois operates the business through Griffin Pty Ltd, which owns two subsidiary companies that are currently dormant. Peter and Lois are the directors and shareholders of Griffin Pty Ltd (1 ORD share each).

5 Griffin Pty Ltd also owns the commercial property in which the business is operated from (valued at $700,000).

6 Outside their business, Peter and Lois owns various bank accounts and amounts in superannuation, but specifically:

a a property in Carindale owned as joint tenants (**Property 1**); and

b a property in Wishart owned as joint tenants (**Property 2**).

7 Property 1 and 2 are valued at approximately the same market valuation, with the commercial property in Griffin Pty Ltd valued lower.

Step 1 – have discussions with key stakeholders to understand their business succession planning intentions

8 It is Peter and Lois' intentions that:

a if Peter passes away or loses capacity, that Chris should take over the management of the business (as Lois wishes to enjoy retirement), however, Lois should obtain Peter's shares in Griffin Pty Ltd;

b on Peter and Lois both passing away or losing capacity, ownership in Griffin Pty Ltd should be passed:

(A) 40% to Chris;

(B) 30% to Meg; and

(C) 30% to Stewie;

c although Stewie wants nothing to do with the business, Peter and Lois would prefer the three children to work together;

d given Chris' involvement in the business, they would like Chris to manage and benefit from the commercial property in Griffin Pty Ltd (with Meg and Stewie receiving Property 1 and 2 under Peter and Lois' Wills).

Step 2 – check whether the current structure of the business is appropriate to achieve the intentions

9 Although the 2 ordinary shares in Griffin Pty Ltd will require splitting to be split 40/30/30 between Chris, Meg and Stewie, the company structure is the most suitable to achieve the intended ownership and management objectives for Peter and Lois.

10 A tricky issue relates to the fact that Peter and Lois would like Chris to benefit from the commercial property, but the commercial property is held in Griffin Pty Ltd (which operates the business).

11 Other than having asset protection concerns of intermingling the business premises with the risk of the family business, steps should be taken to potentially separate the business premises to earmark for Chris.

12 This could be by way of transferring the business premises from Griffin Pty Ltd to a subsidiary and granting Chris (or a nominated entity) an option to acquire the shares in that subsidiary on the death of both of Peter and Lois.[38]

13 Another option (depending on the risk appetite of the client) could include the transferring of the business premises into a subsidiary, but structuring the directorship of that subsidiary to pass to Chris, as well as potentially granting discretionary dividend shares in the subsidiary to Chris (or a related entity).

Step 3 – put in place appropriate legal documents to ensure ownership in the business passes to appropriate family members

14 Wills should be prepared distributing the Peter and Lois' share in Griffin Pty Ltd to each other.

15 In the event Peter and Lois are both deceased, then specific gifts should be made in their Wills to ensure the shares are split 40/30/30 between Chris, Meg and Stewie respectively.

16 Thought could be made in relation to whether there is any benefit of using a testamentary trust for the benefit of each of Chris, Meg and Stewie.

Step 4 – put in place appropriate documentation that implements a framework in how management in the business should pass

17 Governing documents in relation to Griffin Pty Ltd should be clear on who can be appointed as a director.

18 While such documents can outline Chris as a succeeding director, if care is not taken, Meg and Stewie could appoint themselves and effectively outvote Chris in the management of the family business.

[38] There may be potential corporate reconstruction exemptions available in relation to any stamp duty consequences, and any capital gains tax could be managed through the potential use of any small business capital gains tax concessions or the fact that there hasn't been an increase in the market value of the property

19 Such governing documents could thereby require decisions of Griffin Pty Ltd to be made with Chris in a majority, or have him hold effective decision-making ability in the company.

20 To manage any animosity with Meg and her husband, Morgan, the governing documents could allow them to appoint someone onto the board of directors for Griffin Pty Ltd, but ultimately have their voting power to be less than Chris'.

21 Alternatively, key employees or independent advisors could be introduced as directors to manage disagreements between directors.

Step 5 – put in place appropriate documentation documenting the family's values

22 Given the potential animosity between Chris and Morgan, a document outlining Peter and Lois' intentions and objectives should be prepared.

23 Independent third-party advisors should also be considered as potential persons able to mediate disagreements between the family sub-groups, with fall provisions allowing certain parties to 'buy-out' others.

Example 3

Background

1 Stan and Fran Smith owns a family trust (Smith Family Trust) holding and managing a significant commercial property portfolio.

2 Stan and Fran Smith have four children (all with families of their own):

a Hayley, and her husband Jeff;

b Steve;

c Roger; and

d Christine.

3 Stan has had some historical issues with Hayley and Jeff, specifically:

a Stan sold his legal practice to Hayley and Jeff for under market value by way of vendor sale;

b for years since that sale, Hayley and Jeff had been complaining to Steve, Roger and Christine that Stan 'ripped them off';

c to appease Hayley and Jeff, Stan forgave any outstanding amounts owed by Hayley and Jeff equal to over $300,000;

d Stan continued to use Hayley and Jeff as his legal advisors but noted feeling like a 'second class client' to them despite his significant property portfolio.

4 The Smith Family Trust has been set up with the Smith Nominees Pty Ltd as the trustee.

5 Stan and Fran are the only directors and shareholders of Smith Nominees Pty Ltd.

Step 1 – have discussions with key stakeholders to understand their business succession planning intentions

6 It is Stan's vision that his commercial property portfolio be used to help his children and lineal descendants create a 'legacy within the community'.

7 Unfortunately, he strongly believes that Hayley and Jeff would rather liquidate the portfolio built to obtain their share.

8 Despite the assistance provided by Stan to Hayley and Jeff during his lifetime, he was comfortable enough to still provide them with an equal say in his property business conducted from the Smith Family Trust.

9 However, Stan is of the strong opinion that should he be unable to manage the business, his sons, Steve and Roger should be appointed as directors to work with Fran.

10 In the event Stan and Fran are deceased, or have lost capacity, then Steve and Roger would be managing the business for the benefit of the greater Smith family.

11 Unfortunately, after discussing with Steve and Roger about his intentions, they would prefer not to continue the business if it meant having to deal with a difficult sister in Hayley (and her husband Jeff). Specifically, they would prefer to just liquidate the position.

12 Despite his initial disappointment, Stan appreciated Steve and Roger's position and ultimately decided they the decision for the direction of the business should lay with Steve and Roger.

13 That is, if Steve and Roger feels that the family unit could work together, then they would keep the property management business going.

14 Alternatively, if it were to be too difficult, Steve and Roger would be able to make the decision to liquidate the property holdings and split the proceeds equally between each sub-family group.

Step 2 – **check whether the current structure of the business is appropriate to achieve the intentions**

15 Although the current business structure (a discretionary trust) is one where it is difficult to give beneficiaries a precise proportion.

16 The intention of Stan in encouraging his children to work together to create a family legacy is one which suits a discretionary trust.

17 That is, rather than two family members working for the benefit of all four. If it is found only two family members are putting in the effort, they can decide to distribute such benefits to their respective families as opposed to being forced to make distributions for the benefit of the non-participating members.

Step 3 – put in place appropriate legal documents to ensure ownership in the business passes to appropriate family members

18 There is no appointor role in the Smith Family Trust.

19 Therefore, steps must be taken to ensure ownership in the company trustee (Smith Nominees Pty Ltd) pass as intended by Stan and Fran.

20 In Stan and Fran's case, a single testamentary discretionary trust was created in their Will to receive all their assets (in the event both Stan and Fran passes away). This testamentary discretionary trust was structured as follows:

a the initial trustee for this trust was Hayley, Steve, Roger and Christine;

b rules were hardwired into the testamentary trust requiring at least one member from each sub-family group to be involved at the trustee level (whether as an individual trustee, or as a director of a company trustee);

c to foster an environment encouraging all the children to make decisions together, trustee decisions had to be made unanimously by all trustees; and

d although there were broad distribution clauses, default income and capital beneficiaries were structured to be between Hayley, Steve, Roger and Christine in the event of a deadlock between all parties.

Step 4 – put in place appropriate documentation that implements a framework in how management in the business should pass

21 Steps were taken to hardwire the appointment of Steve and Roger as directors on the death or loss of capacity of Stan.

22 Given that the shareholder of Smith Nominees Pty Ltd had to make decisions unanimously between Hayley, Steve, Roger and Christine, it was safe that the directors of Smith Nominees Pty Ltd were limited to Steve and Roger, unless Steve and Roger wished to have Hayley or Christine appointed with them as directors.

Step 5 – put in place appropriate documentation documenting the family's values

23 Due to the historical disputes with Hayley and Jeff, Stan was prepared to let Steve and Roger to make the call in deciding what was to happen with the family business.

24 He also trusted his two sons to make the decision that best reflected his intentions, given the history with Hayley and Jeff was well known by Steve and Roger.