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Passing on the Baton: Business Succession and the Estate Plan

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Introductory comments

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- Detailed paper
- Factors:
  - One v multiple business owners
  - Successor a family member, key employee or third party
  - Effective during lifetime or after death
  - Arm's length v non-arm's length
  - Family business succession

Bringing on new business owners

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- Business trading from an appropriate structure
  - Company – flat tax rate (26%) and ability to retain profits
  - Trust – ability to distribute to others (including a bucket company at 30%)
- Business succession – company or discretionary trust
  - Shareholders and directors
  - Beneficiaries and trustees/appointors
- Does the business need to be restructured?

Case study

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- Real estate business
- Established in 1980’s
- Company trustee
- Beneficiary class including business owner and lineal descendants
- Intention to pass business to daughter and key employee equally

Case study – restructure options

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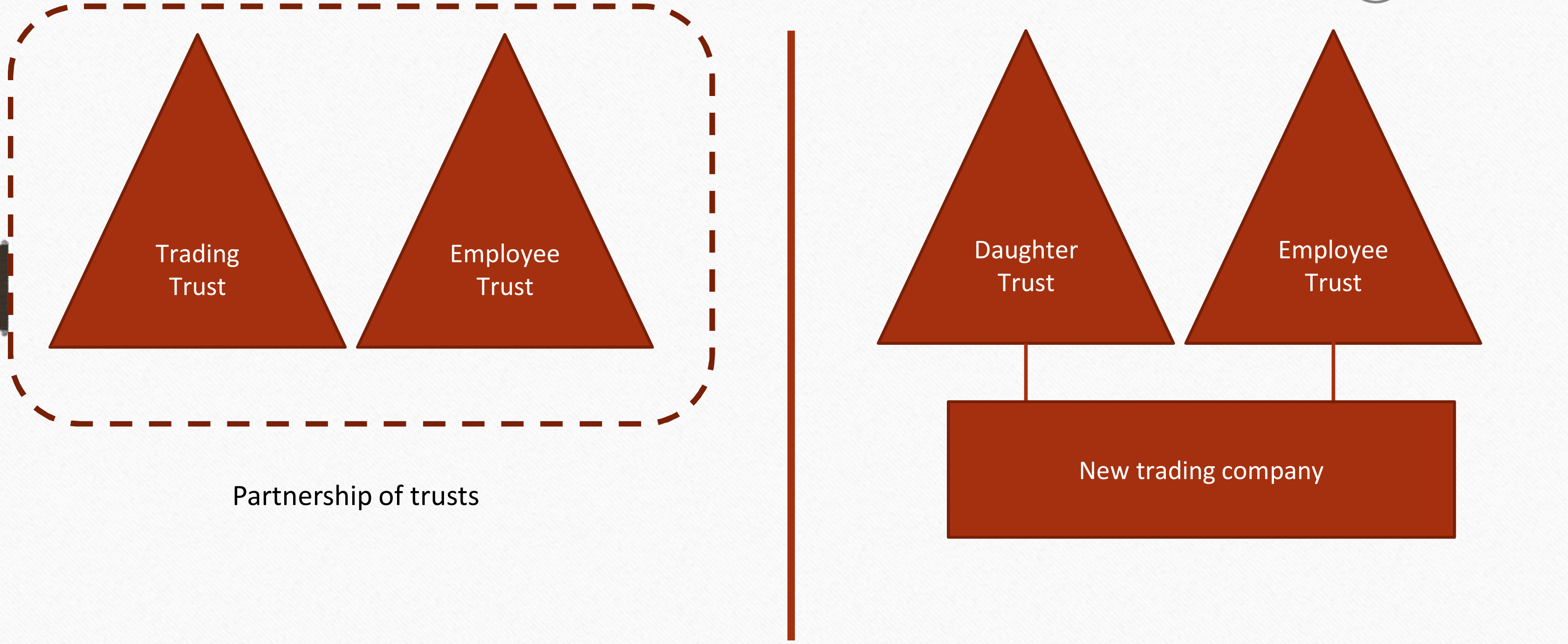

Bringing on new business owners

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- Existing multiple business owners – look to shareholders/unitholders/partnership agreement
- Commercial nature – purchase price, liabilities, due diligence, restraints etc…
- Where consideration and vendor-financed, then query impact on an estate plan – see Fischer v Nemeske [2016] HCA 116
- Capital gains tax consequences on selling business
- Whether partial or full sell-down

Dealing with retained earnings prior to exit

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- Relevant for companies compared to discretionary trusts
- Inability of discretionary trusts to accumulate profits
- Bucket company

- What options are available to extract retained earnings from a company?
- How to deal with franking credits for a departing shareholder?

Case study

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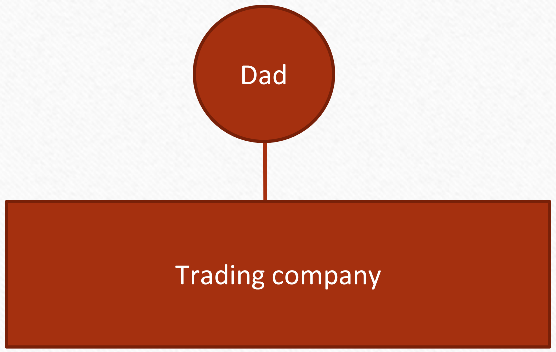

- $800,000 retained earnings
- Wish to use retained earnings in conjunction with pension to self-fund retirement
- Claiming franking credit refunds when income less than $37,000
- Inability for retained earnings to be distribute to spouse
- In ability to retain earnings in company if shares in company sold
- Note – 201F Corporations Act 2001

Case study – holding company

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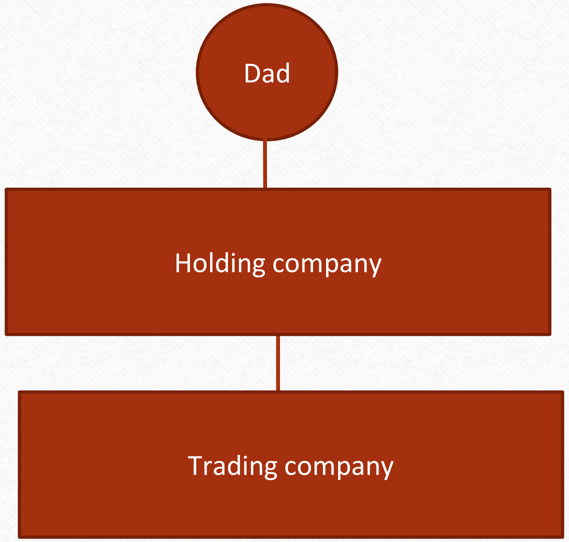
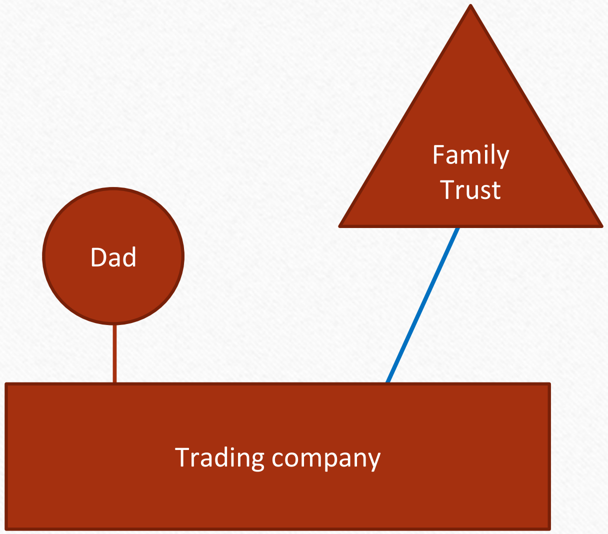


- Retained earnings stored in holding company regardless if business or shares sold
- No 'top-up' tax required for discrepancy in company tax rate when dividends declared as dividends relate to trading income
- Asset protection benefits
- Available CGT rollovers/concessions

Case study – dividend only shares



- Ability to distribute retained earnings to beneficiaries within family group
- Consider utilising holding company with family trust shareholder
- Tax Office risk – Taxpayer Alert 2012/4

Franking credits and discretionary trusts

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- Ability to benefit from franking credits subject to taxpayer being a 'qualified person'
- References to tax legislation repealed in 1 July 2002
- Either holding period rule or the related payments rule satisfied*
- Holding period rule requires shares to be 'at risk' for at least 45 days (90 days for preference shares)
- How to calculate if shares are held at risk by a beneficiary of a discretionary trust?
- Effectively, impossible for discretionary trust unless family trust election is made

Insurance funded buy sell deed

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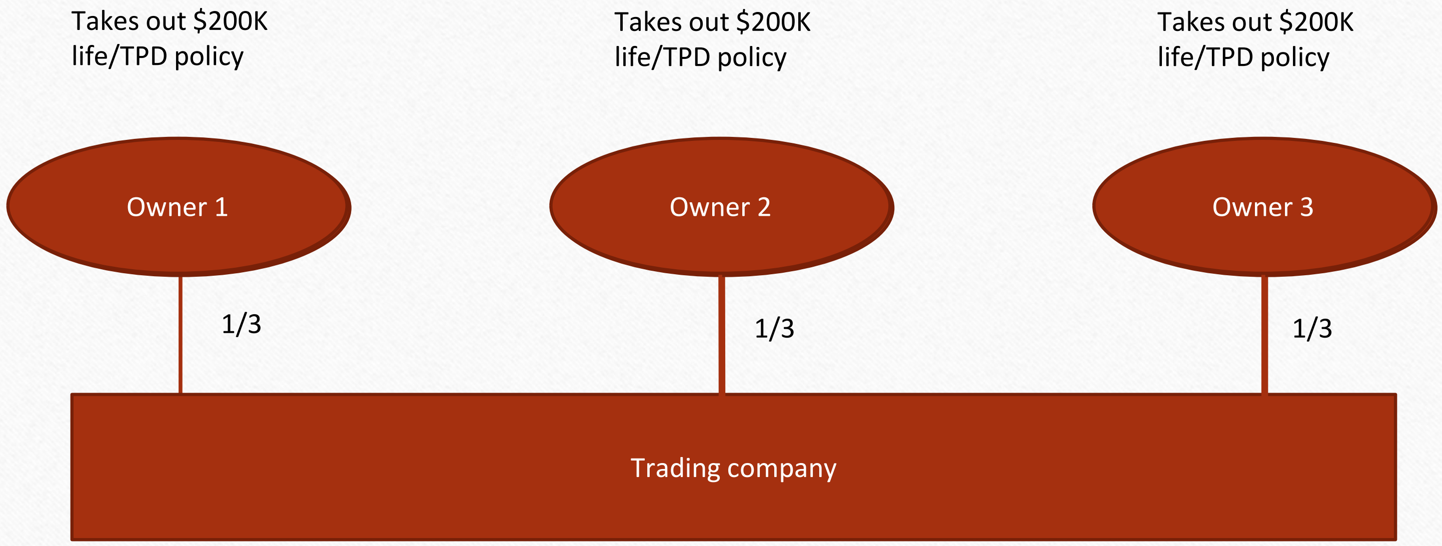
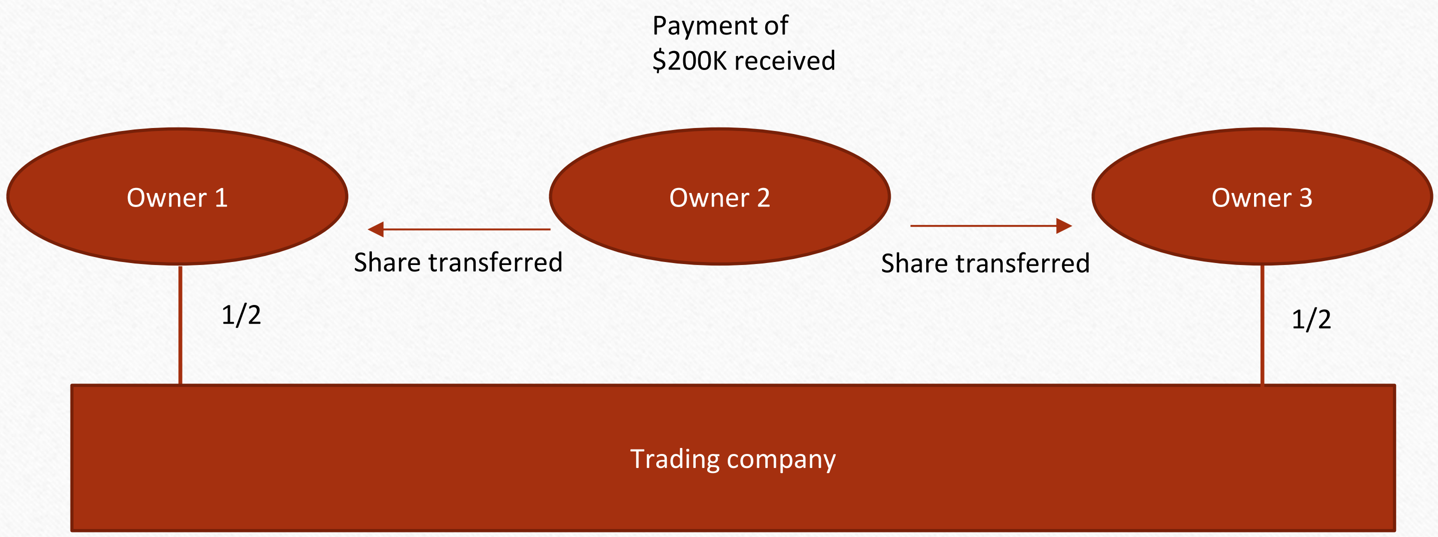


Insurance funded buy sell deed



Buy sell deed – why not others?

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Model	*Why not*
Cross insurance	Unable to receive TPD insurance proceeds tax free unless Principals are related Premiums are not deductible on revenue account and must be paid by Principals
Company-owned insurance	Unable to receive TPD insurance proceeds tax free unless Principals are related Unable to have continuing Principals acquire a cost base uplift in acquired interest Premiums are not deductible and other issues in paying TPD insurance proceeds to exiting Principal
Special purpose trust	Additional trust structure required with specific tailoring (linking entitlements) to ensure TPD insurance proceeds can be received tax free Premiums are not deductible on revenue account and must be paid by Principals
Superannuation	Unable to obtain 'own' occupation TPD policies Additional superannuation law issues to satisfy

Small business CGT concessions

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- Reduction in tax for departing business owner
- Allows cost base to be obtained for incoming business owner
- Available regardless of consideration
- 15-Year Exemption – entire capital gains disregarded
- 50% Active Asset Reduction – capital gain reduced by 50%
- Retirement Exemption – up to $500,000 o f capital gains can be contributed to superannuation
- Small Business Roll-over – defer capital gain for 2 years
- For companies – able to reduce $1 million capital gain to zero per owner
- For trusts – able to reduce $2 million capital gain to zero per owner

Small business CGT concessions

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- 2019 rules – requires $6 MNAV test met
- Company utilises concessions – requires liquidation of the company as no franking credits available on sale price received tax free
- *15-Year Exemption allows full amount to be extracted as non-assessable non-exempt income
- *Retirement Exemption allow up to $500,000 to be extracted and put into superannuation (or straight out if over retirement age)
- Pre-sale restructures impacting 15-Year Exemption rules
- Triggering concessions early

The 'family' factor

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- Academic literature
- Concept of 'socioemotional wealth'

"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"*

- Five factors:
  - **F**amily control and influence
  - **I**dentification of family members within the firm
  - **B**inding social ties
  - **E**motional attachment
  - **R**enewal of family bonds to the firm through dynastic succession

Family business	***Non-family business***
Picking family members into leadership roles in the business regardless of experience as it maximizes 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	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	Management seeking strategies that can maximize profits to the owners (to validate the appointment of such persons in management positions)
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

General application

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- Hardwiring (formal legal documents)
- Flexibility (moral pieces of paper)
- Middle ground?

Passing ownership

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- Ensuring ownership passes to intended beneficiaries
  - Personal
  - Company
  - Trust
- Documentation
  - Will
  - Call options
  - Share transfers/unit transfers (during lifetime)
  - Deed of variations/trust succession documents for trustee/appointor/principal
- Context
  - Will challenges
  - Challenges under separate areas of law – equity and/or corporations law

Management

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- Rules v framework
- Ensuring management passes and transitions seamlessly
  - Integrate now or later
  - Qualifications
  - Independent advisors v family members
  - How decisions are made
  - Vetoing or casting votes
- Documentation
  - Bespoke company constitutions
  - Ensuring company constitutions cannot be overridden (ensuring ancillary/control roles pass appropriately)

Family

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- Managing expectations between family benefiting and family managing
- Need to put in place appropriate procedures and/or frameworks
- Family constitutions and councils
- Frequency of meetings
- Dispute resolution mechanisms

Final comments

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- No one answer
- Every business succession is different
- Ask the right questions and ensure the right documents and frameworks are in place to ensure an as seamless transition as possible

Questions?

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