

# Business Succession Planning

November 2016

Christine Atencia – Financial Adviser, Nexia Sydney

Darren Chinnappa – Superannuation Manager, Nexia Sydney



the next solution

# Disclaimer

Material contained in this presentation is a summary only and is based on information believed to be reliable and received from sources within the market. It is not the intention of Nexia Sydney Financial Solutions Pty Ltd ABN 88 077 764 222 Australian Financial Services Licence Number 247300 that this presentation be used as the primary source of readers' information but as an adjunct to their own resources and training. No representation is given, warranty made or responsibility taken as to the accuracy, timeliness or completeness of any information or recommendation contained in this publication and Nexia Sydney Financial Solutions will not be liable to the reader in contract or tort (including for negligence) or otherwise for any loss or damage arising as a result of the reader relying on any such information or recommendation (except in so far as any statutory liability cannot be excluded). This presentation has been prepared for general information and not having regard to any particular person's investment objectives, financial situation or needs. Accordingly, no recommendations (express or implied) or other information should be acted upon without obtaining specific advice from an authorised representative. Please note past performance may not be indicative of future performance.

# Agenda

1. Reasons for going into business
2. Why is business succession planning important?
3. Buy/Sell Agreements
4. Keeping the business running
5. Running a business through an SMSF
6. Small Business CGT Concessions

# Agenda

1. **Reasons for going into business**
2. Why is business succession planning important?
3. Buy/Sell Agreements
4. Keeping the business running
5. Running a business through an SMSF
6. Small Business CGT Concessions



# Why are you in business?

- Provide for the family
- Flexibility and control of own destiny
- Freedom
- Legacy/succession for family
- Self-funded retirement
- Greater opportunity than being employed

# Agenda

1. Reasons for going into business
2. **Why is business succession planning important?**
3. Buy/Sell Agreements
4. Keeping the business running
5. Running a business through an SMSF
6. Small Business CGT Concessions

# Personal vs Business Insurance

## A person has...

1. Assets
2. Debts
3. Income
4. Expenses

# Personal vs Business Insurance

A person has...	A business has...
1. Assets	1. Assets
2. Debts	2. Debts
3. Income	3. Income
4. Expenses	4. Expenses

There is no difference!

# Personal vs Business Insurance



Family protection is the need to put dollars on the kitchen table to offset the economic effect of losing a family member

# Personal vs Business Insurance



Family protection is the need to put dollars on the kitchen table to offset the economic effect of losing a family member



Business protection is the need to put dollars on the boardroom table to offset the economic effect of losing an owner, key person, guarantor, profit maker

# What are the risks to your business?

- Litigation
- Loss of assets and equipment
- Criminal activity of partner or staff - disputes
- Divorce
- Retirement
- Accident or illness of key employee
- Unexpected death of business partner



# What are the risks to your business?

- Litigation
- Loss of assets and equipment
- Criminal activity of partner or staff - disputes
- Divorce
- Retirement
- Accident or illness of key employee
- Unexpected death of business partner





# Statistics

- **1** in **2** chance a man will have been diagnosed with cancer at some point in their life before the age of 85. This statistic is **1** in every **3** for females \*
- Over **100,000** Australians are diagnosed with cancer each year
- **1** in **6** people will have a stroke in their lifetime ^
- **1** in **3** Australians could be disabled for more than 3 months before turning 65

*\*Source: Cancer Council , Prostate Cancer Foundation of Australia*

*^ Stroke Foundation*

*\*\* Australian Institute of Health and Welfare*

# Statistics

- **37%** of small businesses have heard of 'buy/sell' cover – only **9%** have it
- **53%** of small businesses have heard of 'key person' cover – only **6%** have it

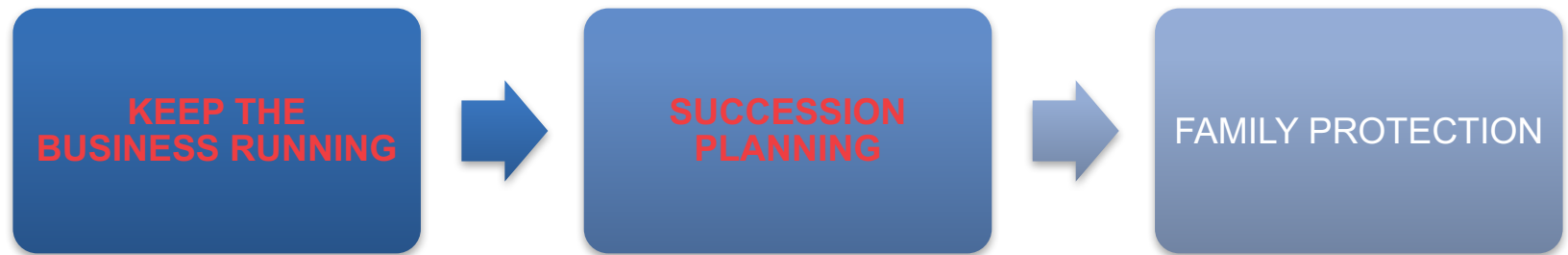
# Would your business survive?

- For 4 weeks – who would run your business?
- For 3 months – who would take care of your business?
- For 6 months or more – would you still have a business?

# Complete business protection



# Complete business protection



# Agenda

1. Reasons for going into business
2. Why is business succession planning important?
3. **Buy/Sell Agreements**
4. Keeping the business running
5. Running a business through an SMSF
6. Small Business CGT Concessions

# What is a business succession plan?

- A financial and tax plan that, in the event that something happens to a business partner, it ensures:
  - Easy transition of control
  - A fair trade
  - The reduction of the impact of Capital Gains Tax
  - A willing purchaser

# Business Succession Planning



## Uninsurable exits

- Transfer to children
- Management buy out
- Dismissal
- Bankruptcy

## Solution

- Exit agreement
- Self funding/finance



## Insurable exits

- Death
- TPD
- Trauma

## Solution

- Buy/Sell Agreement
- Insurance



# Implications of not having a plan in place

- Wind up
- Remaining partners can sell interest to heirs of deceased
- Heirs could take control of share
- Heirs could sell to an outsider
- Remaining partners could buy the interest from heirs of deceased

**Agreement + provision for funding = CERTAINTY**

# What is a Buy/Sell Agreement strategy?

This strategy involves:

- **Creating a legal agreement (buy/sell agreement)**
  - Forces owner to leave business should one of the trigger events occur
  - Forces the remaining owner to buy the departing owner's share
- **Funding for the departure of a business owner**
  - Insurable trigger event – death, TPD, trauma
  - Other trigger events such as retirement – savings/personal assets/borrowed funds

# Business Succession Planning

The owner leaving the business (or deceased estate)

- Fair value for your equity
- Security for you and/or dependants
- Proprietor loan repaid
- Personal guarantee terminated
- Quick resolution

The owner continuing the business

- Smooth succession
- No disruption caused
- Control
- 100% equity
- Loans repaid
- Nil/less debt

# Funding mechanisms

Option	Issues	Cost
Borrowings	Qualification for loan.	Capital sum plus interest over repayment period.

# Funding mechanisms

Option	Issues	Cost
Borrowings	Qualification for loan.	Capital sum plus interest over repayment period.
Vendor finance	No clean break plus credit risk.	Capital sum plus interest over repayment period.

# Funding mechanisms

Option	Issues	Cost
Borrowings	Qualification for loan.	Capital sum plus interest over repayment period.
Vendor finance	No clean break plus credit risk.	Capital sum plus interest over repayment period.
Business asset sales	Ability to realise value.	Opportunity cost = asset's income producing ability.

# Funding mechanisms

Option	Issues	Cost
Borrowings	Qualification for loan.	Capital sum plus interest over repayment period.
Vendor finance	No clean break plus credit risk.	Capital sum plus interest over repayment period.
Business asset sales	Ability to realise value.	Opportunity cost = asset's income producing ability.
Other asset sales	Locating assets, other than goodwill and principal residences.	Opportunity cost = asset's income producing ability.

# Funding mechanisms

Option	Issues	Cost
Liquidation	Ability to realise value on a fire sale basis.	Opportunity cost = loss of future income.



# Funding mechanisms

Option	Issues	Cost
Liquidation	Ability to realise value on a fire sale basis.	Opportunity cost = loss of future income.
Sale to purchaser or employee	Limited market and employee reluctance.	Nil

# Funding mechanisms

Option	Issues	Cost
Liquidation	Ability to realise value on a fire sale basis.	Opportunity cost = loss of future income.
Sale to purchaser or employee	Limited market and employee reluctance.	Nil
Bequest via will	Only practical if heirs want to inherit the business interest.	Nil

# Funding mechanisms

Option	Issues	Cost
Liquidation	Ability to realise value on a fire sale basis.	Opportunity cost = loss of future income.
Sale to purchaser or employee.	Limited market and employee reluctance.	Nil
Bequest via will.	Only practical if heirs want to inherit the business interest.	Nil
Insurance	Ensuring transfer price = agreed value.	Premium cost. Generally the cheapest option available.

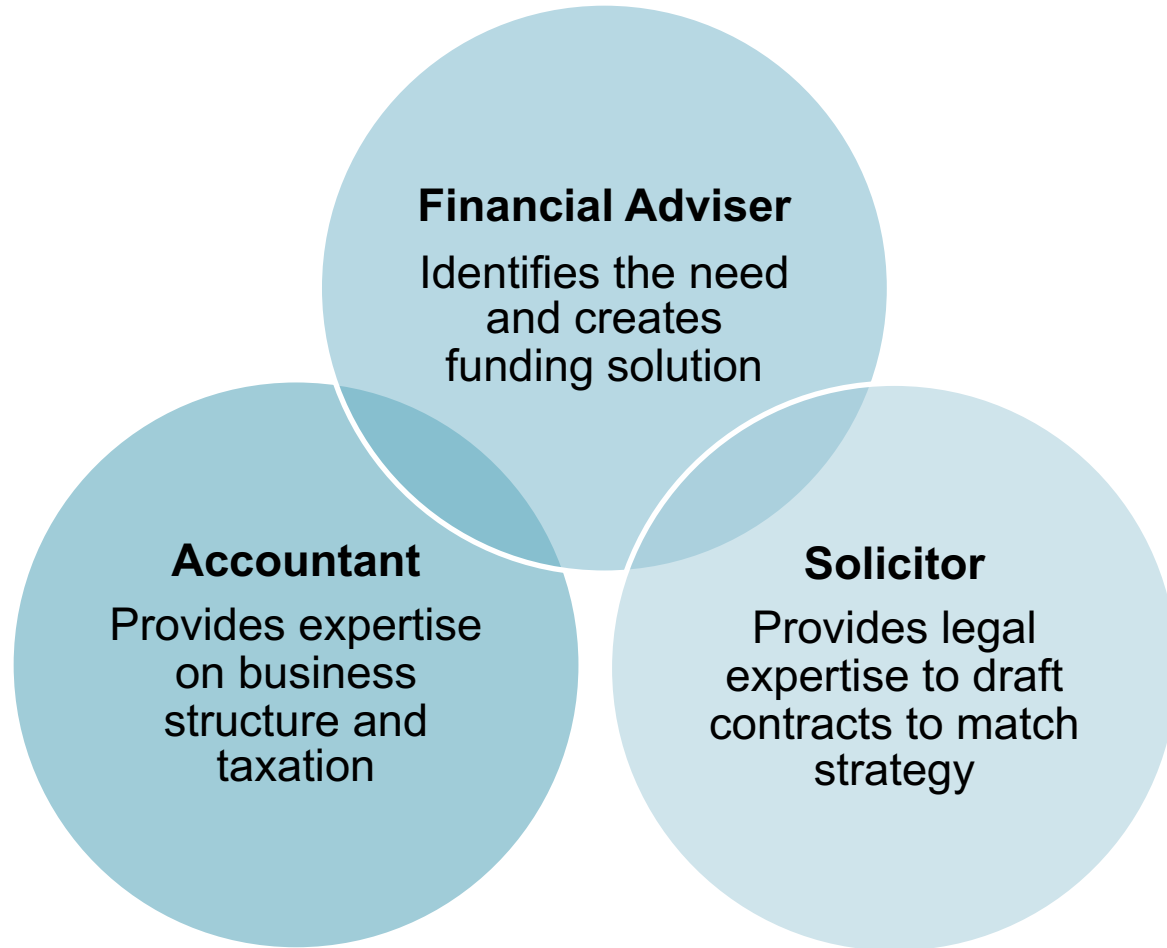
# Buy/Sell Agreements



Buy/Sell Agreements give certainty by:

- Providing the mechanism for the sale of an owner's share in a business should they become sick, disabled, or die
- Ensuring surviving partners own all of the business, and the surviving family receives a fair price for the interest in the business, in a timely way
- Ensuring smooth transition to new ownership, minimal impact on day-to-day management

# Other professionals



# Tax implications - premiums

Item	Deductibility
Are premiums tax deductible?	No
Are benefits included as assessable income?	No

# Tax implications – CGT on proceeds

Insurance	CGT applies:
Life	If the proceeds are received by anyone other than the original beneficial owner and that person/entity acquired the policy for consideration
TPD or trauma	If the proceeds are received by anyone other than the life insured or the insured's relative. Relative is defined as: (a) The person's spouse, (b) The person's parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of that person, or of that person's spouse, or (c) The spouse of a person referred to in paragraph (b).

# Case study

Erin and John run a graphic design business through a company called E & J Graphics. Their accountant has valued their business at \$5m, and they each hold 50% share.

## Erin's personal situation

- Married to Mark, who owns a café – has no experience in the field of architecture
- Under Erin's Will, all of her assets go to Mark

Erin unexpectedly dies from a sudden heart attack...



# Agenda

1. Reasons for going into business
2. Why is business succession planning important?
3. Buy/Sell Agreements
4. **Keeping the business running**
5. Running a business through an SMSF
6. Small Business CGT Concessions

# Running the business

A Key Person is any person whose continued association with the business provides the business with a significant economic gain.

Examples:

- **Managing director**
- **Sales rep** who has strong relationships with large clients
- **Technical employee** with specialist skills that business relies on
- **External supplier** of a critical manufacturing component
- **Non-working shareholder** who puts up personal assets as security

# Implications if key person cannot work

Option	Issues
Realising business assets	<ul style="list-style-type: none"><li data-bbox="600 347 1489 391">■ Fire sale could mean financial loss</li><li data-bbox="600 409 1644 515">■ Assets may be required to generate cash flow</li></ul>

# Implications if key person cannot work

Option	Issues
Realising business assets	<ul style="list-style-type: none"><li>▪ Fire sale could mean financial loss</li><li>▪ Assets may be required to generate cash flow</li></ul>
Borrowing more cash	<ul style="list-style-type: none"><li>▪ Unlikely bank will extend lending if business is in difficulty</li></ul>

# Implications if key person cannot work

Option	Issues
Realising business assets	<ul style="list-style-type: none"><li>▪ Fire sale could mean financial loss</li><li>▪ Assets may be required to generate cash flow</li></ul>
Borrowing more cash	<ul style="list-style-type: none"><li>▪ Unlikely bank will extend lending if business is in difficulty</li></ul>
Creation of sinking fund	<ul style="list-style-type: none"><li>▪ Funds should be used to run or expand the business</li></ul>

# Implications if key person cannot work

Option	Issues
Realising business assets	<ul style="list-style-type: none"><li>▪ Fire sale could mean financial loss</li><li>▪ Assets may be required to generate cash flow</li></ul>
Borrowing more cash	<ul style="list-style-type: none"><li>▪ Unlikely bank will extend lending if business is in difficulty</li></ul>
Creation of sinking fund	<ul style="list-style-type: none"><li>▪ Funds should be used to run or expand the business</li></ul>
Contributing personal assets	<ul style="list-style-type: none"><li>▪ If assets are available, pressure is put on personal life</li></ul>

# Implications if key person cannot work

Option	Issues
Realising business assets	<ul style="list-style-type: none"><li>▪ Fire sale could mean financial loss</li><li>▪ Assets may be required to generate cash flow</li></ul>
Borrowing more cash	<ul style="list-style-type: none"><li>▪ Unlikely bank will extend lending if business is in difficulty</li></ul>
Creation of sinking fund	<ul style="list-style-type: none"><li>▪ Funds should be used to run or expand the business</li></ul>
Contributing personal assets	<ul style="list-style-type: none"><li>▪ If assets are available, pressure is put on personal life</li></ul>
Absorbing from profit and running at a loss	<ul style="list-style-type: none"><li>▪ How long can this be sustained for?</li></ul>

# Capital vs revenue purpose



→ Protects P&L of business

→ Insurance could cover:

- Lost sales
- Recruitment costs
- Training costs
- Temporary replacement

→ Protects balance sheet of business

→ Insurance could cover:

- Repaying debt called in by lender
- Repaying loans to key person



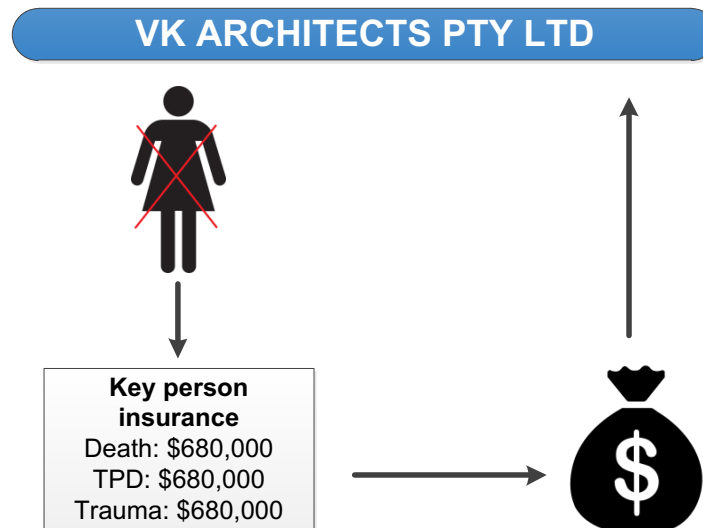
# Key person (revenue) – case study

Victoria is a graphic designer at VK Architects Pty Ltd

- Generates 30% of revenue
- Owns 20% of company shares
- Salary is \$200,000
- Would take 12 months to replace
- Net profit + fixed costs is \$2mil

# Key person – how much is reasonable?

Calculation	Total
Profit percentage (\$2m x 30%)	\$600,000
Recruitment costs	\$40,000
Training	\$40,000
<b>Total</b>	<b>\$680,000</b>



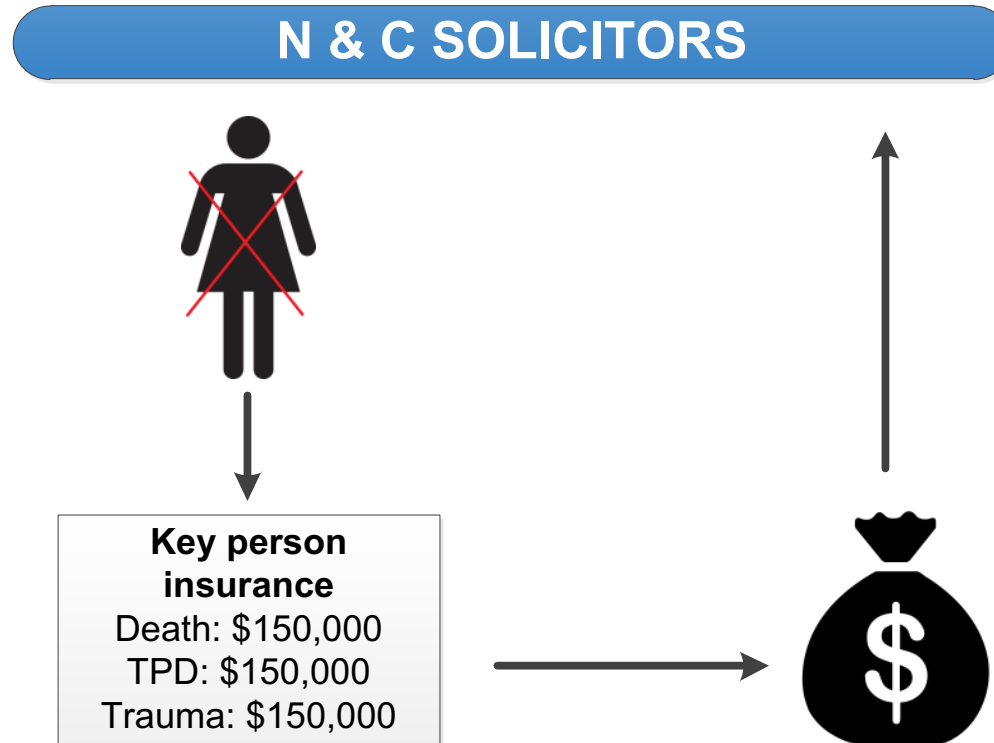
# Key person (capital) – case study

Natalie and Chloe are partners at N & C Solicitors Pty Ltd

- Required \$150,000 upon establishment to set up an office
- Were only able to obtain a loan of Natalie agreed to be guarantor on the loan, as she owned her home worth \$600,000

Should Natalie ever leave the business for any reason, she would require that the loan be repaid.

# Key person (capital) – case study



# Tax implications – key man insurance

Item	Revenue purpose	Capital purpose
Are premiums tax deductible?	Yes	No
Is the benefit included in assessable income?	Yes	Generally no
Is CGT payable on the benefit?	No	Yes, if: <ul style="list-style-type: none"> <li>▪ It is for trauma or TPD cover and is not paid to the life insured or relative*</li> <li>▪ Beneficiary is not the original owner and policy was transferred for some consideration</li> </ul>

*Relative: spouse, parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendent or adopted child of that person, or of that person's spouse, or the spouse of a person referred*

# Agenda

1. Reasons for going into business
2. Why is business succession planning important?
3. Buy/Sell Agreements
4. Keeping the business running
5. **Running a business through an SMSF**
6. Small Business CGT Concessions

# Running a business through an SMSF

- An SMSF generally cannot run a business
- SMSF's can invest in an entity that carries on a business.

Factors to consider before investing in an entity carrying on a business are:

- Sole Purpose Test
- Trust Deed
- Investment Strategy
- Arm's Length Rules

# Can a SMSF invest in a private entity carrying on a business?

Yes...

provided that it complies with the SIS Act restrictions on related party acquisitions and in-house assets.



# Restrictions on Acquisitions from a Related Party

- SMSF trustees are prohibited from acquiring an asset from a 'related party' of the Fund except for:
  - Business Real Property
  - Listed Securities
  - Widely Held Unit Trusts (includes Managed Funds)
  - In-house assets (under 5% limit)
- The term 'related party' is defined as any of the following:
  - A member of the Fund
  - A standard employer sponsor of the Fund
  - A Part 8 Associate of a member or standard employer sponsor

# Agenda

1. Reasons for going into business
2. Why is business succession planning important?
3. Buy/Sell Agreements
4. Keeping the business running
5. Running a business through an SMSF
6. **Small Business CGT Concessions**

# Small Business CGT Concessions

- Small Business CGT Concessions allow owners to:



- Disregard or defer the capital gain on sale of an active business asset
- Contribute the capital gain or sale proceeds into Super

# Basic conditions to qualify

- The basic conditions to qualify for these concessions are:
  - The business has an aggregated turnover less than \$2m; or
  - The maximum \$6m net asset value test is satisfied; or
  - The asset was used in a closely connected small business



# Active Asset Test

- CGT asset must have been an active asset for at least:
  - 7.5 years if you have owned it for more than 15 years,
  - Half of the test period if you have owned it for 15 years or less
- Test period begins when you acquire the asset and ends at the earlier of:
  - The time of the CGT event or
  - When the business stopped

# What concessions are available?

- The 4 Small Business CGT Concessions available are:
  1. 15-year exemption
  2. 50% active asset reduction
  3. Retirement Exemption
  4. Rollover



# 15-Year Exemption

- Capital gain on sale of active asset is tax exempt
- Can contribute sale proceeds of up to \$1.415m to Super



- Eligibility conditions:
  1. Business continuously owned active asset for 15 years and
  2. Over age 55 and
  3. Retiring or permanently incapacitated

# 50% Asset Reduction



- Reduce capital gain on active asset by 50%
- Can contribute sale proceeds of up to \$1.415m to Super
- Eligibility conditions:
  - There are no additional eligibility rules for the 50% active asset reduction



# Retirement Exemption

- Capital gains exempt up to lifetime limit of \$500,000
- Eligibility Conditions:
  - A written choice to disregard the capital gain is made
  - If under 55, exempt gains must be paid into Super



# Rollover

- Defer all or part of a capital gain for two years or longer if:
  - You acquire a replacement asset or
  - Incur expenditure on making capital improvements to an existing asset
- Eligibility Conditions:
  - Asset must be an active asset at the end of the replacement period

# What to do if you are considering selling your business?



Nexia advisers are here to help you!

# Conclusion

- Buy/sell strategy protects your interest in the business and the interest of your co-owners, ensuring ease of control and fair trade
- Key man insurance ensures your business continues to operate should a key person no longer work there
- SMSF's can invest in an entity carrying on a business provided that it complies with the restrictions stipulated in the SIS Act
- Small Business CGT concessions can disregard or defer capital gains on sale of active assets by business owners.

# How We Operate

**Complimentary meeting**

*No cost to you*

**Fee for service**

*Complete objectivity*

**Hourly rate**

*Varies depending on the complexity  
of your situation*

**No commission**

*Our advice is in your best interest*

# Contact Details

- Christine Atencia  
Email: [catencia@nexiasydney.com.au](mailto:catencia@nexiasydney.com.au)  
Phone: (02) 8264 0655
- Darren Chinnappa  
Email: [dchinnappa@nexiasydney.com.au](mailto:dchinnappa@nexiasydney.com.au)  
Phone: (02) 8264 0649
- Website: [www.nexia.com.au](http://www.nexia.com.au)

Thank you