Business Succession Planning

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Agenda

1. Reasons for going into business
2. Why is business succession planning important?
3. Buy/Sell Agreements
4. Keeping the business running
5. Can you run a business in a 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

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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/business partner**
- **Unexpected death of a key employee/business partner**

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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*

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Complete business protection

KEEP THE BUSINESS RUNNING → SUCCESSION PLANNING → FAMILY PROTECTION

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What is a business succession plan?

- A **financial** and **tax** plan that, in the even 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

Implications of not having a plan in place

- Wind up
- Remaining partners can sell interest to beneficiaries of deceased
- Beneficiaries could take control of share and enter the business
- Beneficiaries could sell to an outsider
- Remaining partners could buy the interest from the beneficiaries of deceased

Agreement + provision for funding = CERTAINTY

What is a Buy/Sell Agreement strategy?

This strategy involves:

- **Creating a legal agreement (buy/sell agreement)**
  - An option to purchase the outgoing owner’s share
  - A requirement that the remaining owner/s will purchase 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

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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.

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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.

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Business Succession Planning

The owner leaving the business (or deceased estate)	The owner continuing the business
• Fair value for your equity • Security for you and/or dependants • Proprietor loan repaid • Personal guarantee terminated • Quick resolution	• Smooth succession • No disruption caused • Control • 100% equity • Loans repaid • Nil/less debt

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Other professionals

Financial Adviser

Identifies the need and creates funding solution

Accountant

Provides expertise on business structure and taxation

Solicitor

Provides legal expertise to draft contracts to match strategy

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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

Case study

Erin and John are joint owners of a successful graphic design business. 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 graphic design
- Under Erin's Will, all of her assets go to Mark

Erin is involved in a car accident and passes away….

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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

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Implications if key person cannot work

Option	Issues
Realising business assets	▪ Fire sale could mean financial loss ▪ Assets may be required to generate cash flow
Borrowing more cash	▪ Unlikely bank will extend lending if business is in difficulty
Creation of sinking fund	▪ Funds should be used to run or expand the business
Contributing personal assets	▪ If assets are available, pressure is put on personal life

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Absorbing from profit and running at a loss	▪ How long can this be sustained for?

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Capital vs revenue purpose

Revenue

- Protects P&L of business
- Insurance could cover:
  - Lost sales
  - Recruitment costs
  - Training costs
  - Temporary replacement

Capital

- Protects balance sheet of business
- Insurance could cover:
  - Repaying debt called in by lender
  - Repaying loans to key person

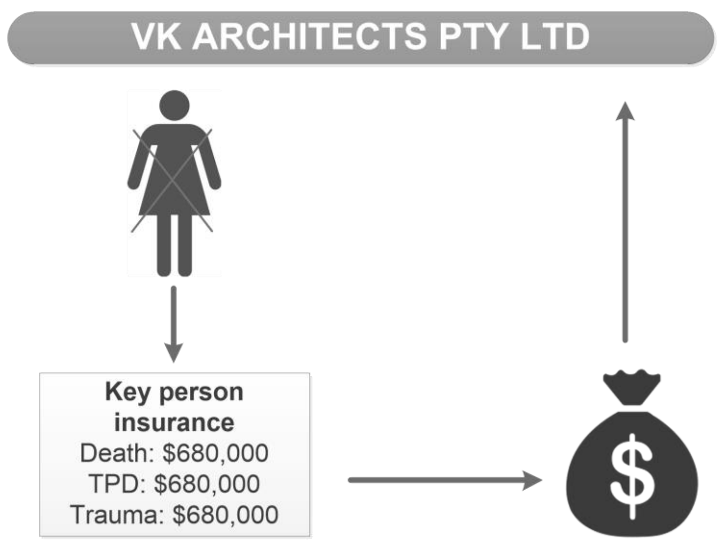
Key person (revenue) – case study

Victoria is a senior associate at VK Architects Pty Ltd

- Generates 30% of revenue
- Salary is $200,000
- Would take 12 months to replace
- Net profit is $2mil

Key person – how much is reasonable?

Calculation	Total
Profit percentage ($2m x 30%)	$600,000
Recruitment costs	$40,000
Training	$40,000
Total	**$680,000**



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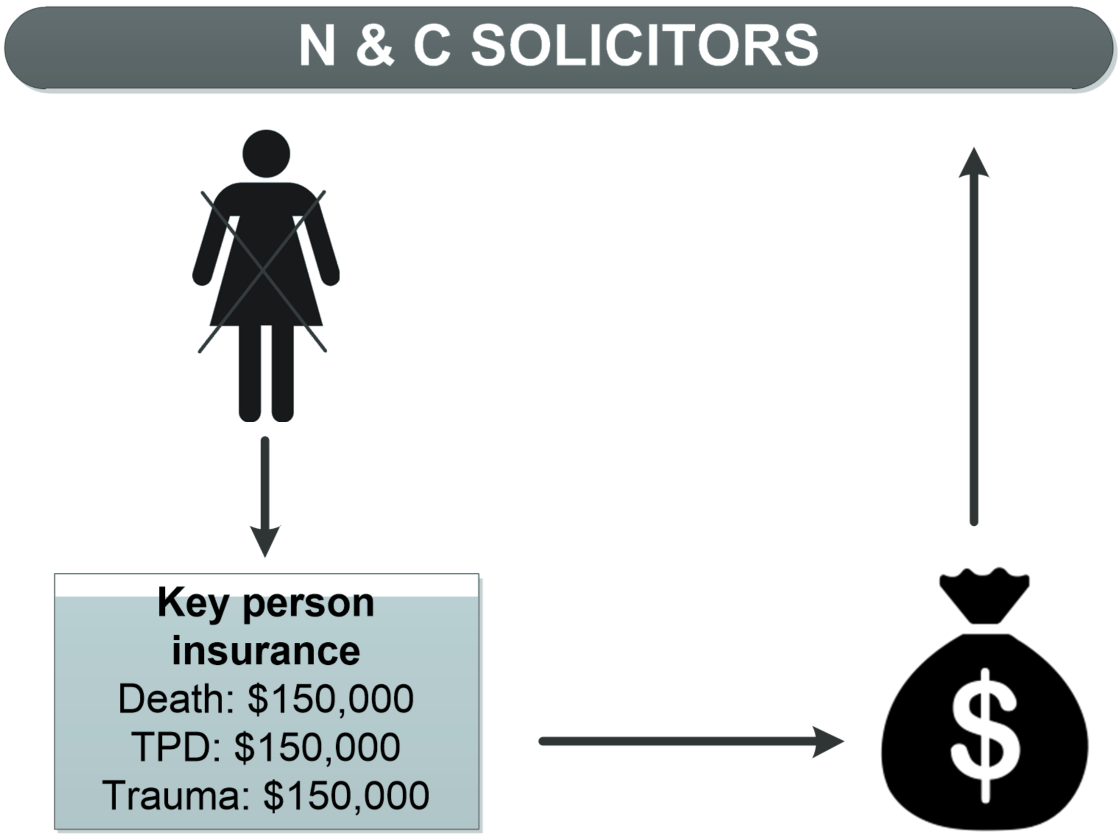
Key person (capital) – case study

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



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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: ▪ It is for trauma or TPD cover and is not paid to the life insured or relative* ▪ Beneficiary is not the original owner and policy was transferred for some consideration

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Can your run a business in an SMSF?

Why run a business in a SMSF?

- Access to capital
- Income concessionally taxed

Can you run a business in a SMSF?

- Nothing in the SISF Act the prohibits it
- Need to comply with SIS Act and imposed limitations
- Sole purpose test

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

Yes...

Provided that it complies with the SIS Act restrictions including:

- Acquisition at market value
- Restrictions on acquisition from related party
- In-house asset limit
- Non-arm's length income

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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

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Why are the Small Business CGT caps important?

2017 Super Reforms have reduced:

- Concessional Contribution (CC) Cap to $25,000
- Non-concessional Contributions (NCC) Cap to $100,000
- Ability to make NCC – now subject to $1.6m super balance test

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Small Business CGT Concessions and Contribution Caps

Small Business CGT Concessions contributed to Super are:

- Excluded from CC and NCC caps
- Not subject to $1.6m super balance test

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Eligibility Criteria for Small Business CGT Concessions

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

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Active Asset Test

- An Active Asset is a CGT asset owned and used or held ready for use in the course of carrying on a business.

- The 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 if 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

Types of Small Business CGT Concessions

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 $1.445m to Super

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

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50% Active Asset Reduction

- Reduce capital gain on active asset by 50%

- 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

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Does the retirement exemption actually require you to retire?

Contrary to its name, the retirement exemption does not require the business owner to actually retire.

However, it imposes specific the following conditions:

- If the business owner is under age 55, the exempt gains must be paid into a complying super fund or RSA
- If the business owner is over 55, the exempt gains are not required to paid into a complying super fund or RSA

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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

- Replacement Period:
  - Period starting one year before and ending two years after the last CGT event in the year for which the rollover is obtained

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Ability to defer CGT Contributions

If owner is a company or trust, payment must be made to the individual within:

- 15-year exemption: Two years after CGT event
- Retirement exemption: Later of 7 days of making election or receiving capital proceeds

Once payment received, individual has 30 days to make super contribution.

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Contribution timing issues

Timing rules dictate when CGT contribution must be made

- Vary depend on entity that owns the active asset
- Contribution assessed against NCC if not made within required timeframe

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Ability to defer CGT Contributions

If owner is an individual, contribution must be made by the later of:

- Tax return lodgement date
- 30 days after receiving capital proceeds

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In-specie Contributions of Business Real Property (BRP)

- Contrary to their previous views, the ATO's current view is that CGT event must happen before the contribution.
- Transfer of BRP to Super cannot occur under CGT cap as CGT event and contribution occur at the same time.
- A follow-up cash contribution of the amount is required to qualify for relief under the retirement or 15-year exemption.

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What to do if you are considering selling your business?

Nexia advisers are here to help you!

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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.

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Thank you