Business succession advice: Why it is important...

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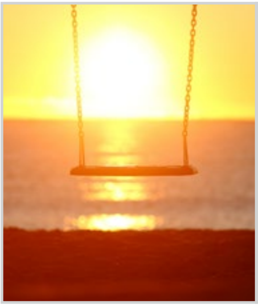
Nick and Tom have been running a business together for the past 15 years.

The business has over 20 employees.

Annual turnover amounts to $10 million.

Nick and Tom are unconvinced of the benefits of personal insurance to protect their equity in the business.

They have a handshake agreement in place and believe that the business can draw on its capital should the requirement to 'buy out' one another arise in the future.



Nick unexpectedly passes away. His wife, Jen, inherits the equity (shares) in the business.

Jen wants to sell the shares she has inherited from Nick.

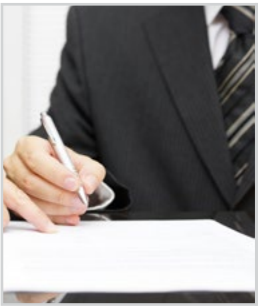
Tom offers to pay Jen $2 million for Nick's shares.

Jen suspects that the shares are worth more than $2 million and requests an independent valuation.

The valuation reveals the shares are actually worth $3 million.

Tom tells Jen that he cannot source the required $3 million to buy the shares.

Jen insists on an immediate payout. She has lost trust in Tom and just wants a clean break.



12 months on, Jen and Tom remain gridlocked. Tom has been unable to source the entire $3 million required to buy out Jen from the business.

All this could have been avoided had Nick and Tom entered into a buy/sell agreement with supporting insurance policies to fund the exchange in shares in the business.

The agreement could have provided for a seamless transfer of Nick's ownership interest to Tom whilst ensuring Jen received adequate consideration for relinquishing the business equity she inherited from Nick.

A buy/sell agreement may help safeguard a business owner's equity upon an involuntary departure from the business.

Put simply, a buy/sell agreement is like a will for a business. When the agreement is well-executed and funded, it is an effective mechanism for business owners to transfer equity and/or control if something should happen to one of the owners. And, unlike a handshake agreement, a good buy/sell agreement provides transparency and certainty to all parties involved.

To work effectively a buy/sell agreement needs to be funded. In other words, the surviving owner will often need the funds to 'buy out' the equity of a departing owner. There could be a range of funding options available at any given time however one that works particularly well, and that may avoid having to draw on business assets, is something as simple as an insurance policy.

Extending the case study – how an insurance funded buy/sell agreement could have helped Tom following Nick's death.

Let's assume that Nick and Tom had a legally binding buy/sell agreement in force at the time of Nick's death. In accordance with this buy/sell agreement, Nick personally owned a $3 million life insurance policy in line with the value of his equity in the business. Nick passes away and, Jen, as the nominated beneficiary is paid $3 million tax free.

Tom then triggers an option in the buy/sell agreement that requires Jen to transfer the shares she has inherited to himself. But unlike an ordinary share purchase transaction, Tom doesn't actually have to outlay $3 million on settlement. That's because the buy/sell agreement recognises the $3 million insurance policy proceeds received by Jen as consideration for the sale of the shares. In other words, Jen is deemed to have received $3 million in sale proceeds by virtue of her being the nominated beneficiary on Nick's life insurance policy – taken out specifically for this purpose.

In the end, Jen has received $3 million tax free for transferring the equity (she inherited from Nick) to Tom. Note that Jen may still be liable for CGT on the disposal of the shares based on their market value at the time. Meanwhile Tom has assumed full control of the company as the sole shareholder/director.

There are alternative insurance policy ownership options that can be utilised in business succession arrangements and also ways to deal with shortfalls in funding. Their appropriateness will depend on the relevant circumstances in each case.

For more information contact your AIA Australia Client Development Manager.

04/17 – IAS3345