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Unplanned succession: How to make sure your business survives you

Life challenged. Unplanned succession. Any way you put it, death is still a subject most of us would rather avoid. Statistically though, it's hard to avoid.

Smart business owners are spending more time on their succession planning. Their business represents a valuable asset and effective succession planning will maximise the value of that asset and the capital that can be realised from it. But what happens if something happens to the business owner, a partner or key director? Death, trauma or critical illness, all trigger an 'unplanned succession' event. Any one of these events can change the profile of the business and drastically affect its value. Even where the disruption to the business can be managed, how do you fund the unexpected need to buy out a partner or shareholder? And, how can this be done in the most tax effective way, providing certainty for all sides and removing the risk to the business?

Current statistics tell us that before the age of 70, 68 per cent of men and 47 per cent of women will die or suffer from cancer, a heart attack, a stroke, undergo bypass surgery or suffer some other major sickness or disease. At some stage, nearly every business is likely to be affected by death or ill-health.

This issue, left to chance, increases the risk for the business and also for the business owners. So what can you do to protect your business from unplanned succession?

Unplanned succession is best addressed by having agreements in place supported by an insurance funding mechanism that allows for an orderly transition. Most commonly these agreements are in the form of a buy/sell agreement or an option agreement. The agreements do not necessarily have to be complex. The key issues are to define the trigger events, agree the valuation mechanism and then have an agreed process to manage the transaction. Generally, the more prescriptive you can be the better. The objective is not to simply make a statement of intentions but to remove any uncertainty and have a clear agreement that all parties can work with.

Funding a buy/sell agreement is normally managed through specialised insurance cover.

How insurance contracts are structured (who the owner is, who 'pays' the premium, whether the policy is held inside or outside the superannuation system etc) has a big impact on the tax deductibility of the premiums, the tax status of the benefits and the flexibility of how the arrangement can be structured. Whether or not the proceeds of an insurance payout are subject to taxation can have a significant impact on the final amount received.

For example:

- Trauma polices cannot be held inside the superannuation system.
- If key person insurance is structured to replace a revenue stream, then the insurance premiums will generally be tax deductible and the benefits will be taxable. However, if the key person insurance is structured to replace capital (to repay a business loan, say) then the insurance premiums will not be tax deductible and the benefits will usually not be taxed (except for trauma cover).

In addition to the ordinary tax issues there are also capital gains tax and fringe benefit tax issues to consider. The message here is 'don't rush out and put a policy in place believing that it is as simple as that.' How the policy is structured could have a significant impact on the end position. And, there is no one solution that is right for everyone. The best structure will depend on your particular circumstances. This is an area that requires careful review and advice.

Succession agreements should be a must for any entity where you have unrelated parties as shareholders, unit holders or partners. Done properly, they ensure that the business will not be put at risk from an unexpected death, protect the surviving shareholders from having to find large amounts of money with little or no notice, and also pay out the estate for an agreed value of their share in the business. All of the stakeholders can have certainty on the outcomes if something unexpected occurs.

Managing unplanned succession can be confusing and too often it is not managed because it is too hard. There are a clear series of steps that need to be followed:

1. Work out what you would like to achieve
2. Understand the tax impacts and the options you have
3. Consider what needs to be in your buy/sell agreement and have that prepared
4. Arrange appropriate insurance that meets the requirements of the agreement and your tax objectives.

For advice and assistance to manage your business succession needs (planned or otherwise!), talk to your adviser today.

ATO reveals its targets

Last month, the Australian Taxation Office released its compliance program for 2008/2009 which highlights who the ATO will focus on and why.

Superannuation is a focus with the rapid growth in Self Managed Superannuation Funds (there were 33,000 new funds registered in 2007/2008 alone). Around 380,000 SMSFs currently hold more than $285 billion in assets - about 25% of all assets in Australia's superannuation system. The ATO will be looking closely at contributions to and withdrawals from superannuation funds to ensure they comply.

For employers, superannuation guarantee payments are in the spotlight. Last year, more than 800,000 employers withheld and paid more than $110 billion to the ATO on behalf of their employees (about 43% of net tax revenue). Employees are being encouraged to report employers who fail to meet the requirements.

Company directors and executives can expect closer attention as well. The focus is on under-reported income (particularly where shares and options have been received as part of a remuneration package), executives and directors of private and foreign-owned companies, and finally, those involved in takeovers.

If you receive partnership or trust distributions you can also expect to come under scrutiny. In fact, the ATO are already underway with a data-matching program that compares the distributions and dividends declared on partnership and trust tax returns with the amounts declared by the recipients of those distributions.

Finally, as always, the cash economy is a highlight. Particular attention is being given to building and construction, restaurants and cafes, and some parts of retailing. This financial year, the ATO will undertake 5,000 cash economy reviews and audits. Data matching is the primary way the ATO are identifying who to pursue with information provided to the ATO from insurance providers, shopping centre operators and regulatory authorities.

Data matching is also used to identify people who appear to be living beyond their means - where their reported income is inconsistent with their spending. For example, they match tax return data against information from government licensing bodies on luxury cars and boats.

Are you ready for another round of tax reform?

Late last month, the Government announced the beginning of the "most comprehensive examination of the tax system in over 50 years". The review will look at:

- The balance of taxes on work, investment and consumption and the role for environmental taxes
- Further enhancements to the tax and transfer system facing individuals, families and retirees
- Taxation of savings, assets and investments, including the role and structure of company taxation
- Taxation of consumption and property and other state taxes
- Simplifying the tax system, including the interactions between federal, state and local government taxes
- Emission trading.

Untouched is the current 10% GST and tax free super for the over 60s.

Quote of the month

You must be the change you wish to see in the world.

Mohandas Gandhi

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