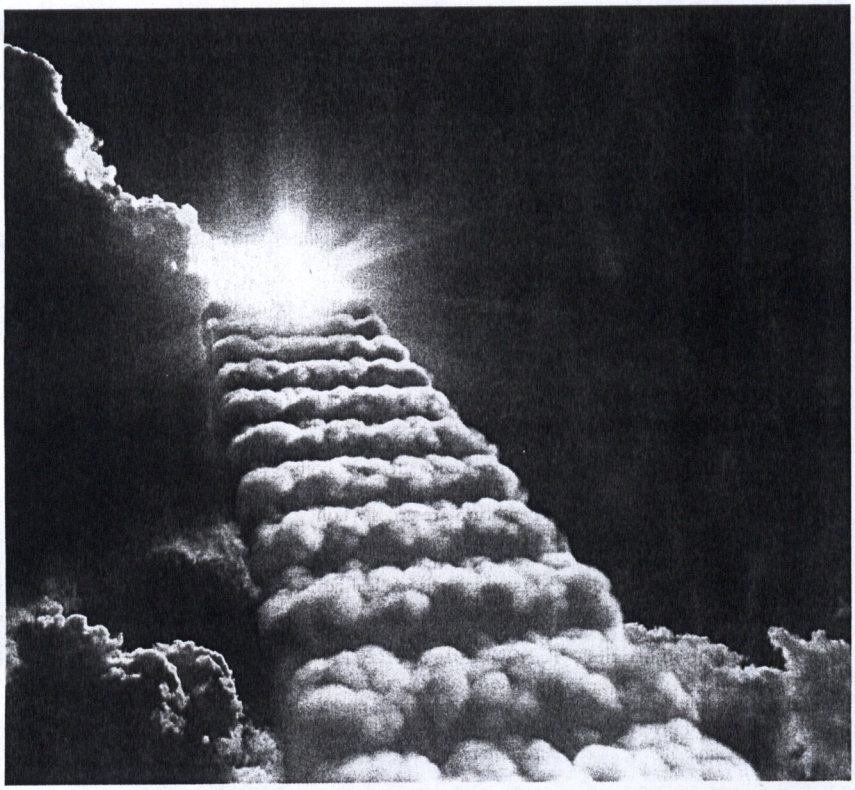
Taking succession to a higher level



Planners should work with referral partners to achieve the best business succession outcome, writes JON DE FRIES.

A relatively small but growing number of advisers who have small to medium enterprises as part of their client base are offering business succession advice and facilitating an advice process that encompasses both planned succession events, such as retirement of a business principal or sale of a business, and unplanned events such as death, disablement or critical illness of a business principal.

As part of the process, advisers should engage other professionals, such as accountants, solicitors and business brokers. The accountant in particular needs to be engaged:

- to ensure they understand the need for succession planning and the consequences of only looking in the 'rear-vision mirror' in giving advice to their business clients;
- in order to identify clients who require advice and refer them to the adviser. It will generally be the accountant who knows the client best and is seen by the client as the primary adviser to the business; and
- as they have a significant and often crucial role to play in the process of formulating the advice. For example, it is the accountant who will provide crucial input such as the business entity structure 'mud map' and business valuation.

The following case study is an illustration of succession planning gone wrong because the accountant was not involved in the process.

Case study

Dad operated his business with his two adult sons from his first marriage, with their family trust as the operating entity. He had remarried and, as is often the case, the relationship between his sons and his new wife was strained. This led to some unease on Dad's part in regard to his estate plan.

This prompted Dad to work out his succession plan with his solicitor. The desired outcome was for:

- his wife to be the beneficiary of his estate – she would inherit the home and other assets together, worth $2 million; and
- his sons to take over control and running of the business, worth $2.8 million.

Accordingly, the solicitor prepared the will and amended the trust deed so the two sons would become the appointers and trustees of the family trust in the event he died.

As the business was carried on by a family discretionary trust:

- it would not devolve to Dad's estate on his death as he did not own – that is, was not presently entitled to – the assets of the business; and
- a buy-sell agreement between Dad and the sons was not necessary or even possible as no party owned anything to buy and sell.

Beneficiaries of family trusts, which are discretionary trusts, have no entitlement to the assets held in trust until the trustee exercises discretion and distributes income or capital in their favour.

Some years later, Dad passed away and, as planned, his wife inherited the house and other assets forming part of his estate, and the sons took over control of the trust and therefore the business.

However, it is common for family trusts to not only have beneficiaries but also creditors. The significance of beneficiaries who are creditors can often be overlooked.

The reason family trusts, particularly those that carry on a business, tend to owe money to beneficiaries is that unless the trustee distributes all earnings, profits and realised capital gains for a financial year, the trustee is generally taxed on these amounts at a flat rate of 46.5 per cent.

One of the benefits of family trusts is the ability to stream various classes of income to the most appropriate beneficiaries in whose hands the distributions are taxed so that a lower amount of tax overall is paid in comparison to business structures where owners have a fixed entitlement.

However, the flipside to this flexibility is the inability to retain earnings within the trust as a company can generally do without the punitive consequence of income being taxed at the top marginal tax rate.

So distributions get paid to the beneficiaries at least once a year. When the beneficiaries become presently entitled to the distribution, they declare the distribution in their tax returns.

However, it is common practice for family trusts carrying on a business to make the distributions 'on paper' to retain the cash for use in the business, so the trustees end up owing the money to the beneficiaries. Over the years, these loan accounts, called 'unpaid present entitlements' build up.

Further, the loan accounts often do not have documented terms, which means they are 'at call'. Beneficiaries owed money can generally demand payment within seven days at any time.

Returning to Dad's case, while the business was worth $2.8 million, the trust owed Dad $1.8 million. The executor of Dad's estate was obliged to call in the loan as it was part of his estate, whose sole beneficiary was the wife.

The only courses of action for the sons are to acquiesce to the demand and sell the business in order to repay the loans or take their chances in court and challenge the will.

In creating a succession plan, Dad and the solicitor had considered what assets would and would not form part of the estate and prepared a will and amended the trust deed accordingly.

However, they failed to consider the financial statements of the trust and realise that the effective control of the trust was not at appointer/trustee level, but in the hands of the trust's creditors.

This is one of the reasons the involvement of an accountant, who either prepared or can understand the implications of the entities' financial statements, working with the adviser and solicitor is best practice in succession planning.

One solution to the above outcome would have been for the adviser, having engaged the accountant in the process and identified the loan issue, to have recommended and arranged asset (debt) protection. That is to either have arranged for:

- the trustee of the family trust to own a life policy on Dad's life for $1.8 million, so the trust received this cash upon his death and had the funds to repay the loan to Dad's estate; or
- Dad to self-own a life policy. On death, the estate would have received the policy proceeds, with Dad's will forgiving the loan.

If Dad was not insurable at the time his succession planning was being formulated, legal advice could have been sought in regard to strategies such as forgiving the loan in the will, including the sons as beneficiaries of the estate or amending the terms of the loans to provide a more reasonable repayment schedule.

The ideal model in creating a succession plan is the financial adviser, accountant and solicitor working together, with the adviser playing a facilitation role so the process does not get bogged down.

Importantly, the financial adviser should identify and document the client's goals and aspirations at the outset so they can be used as a reminder to all parties of the importance of the succession plan being adhered to in a timely manner.

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