

Business succession agreements

If you have clients who are business owners, then business succession planning will be an important part of the overall financial strategy you develop for them and their family. This is particularly the case if your client operates a business with one or more partners or associates.

Business succession planning is the process of protecting a person's investment in a business in the event a business partner exits the business either voluntarily (e.g. due to retirement) or involuntarily (e.g. due to death, total and permanent disability or trauma). For the same reason each of us insures our home, car and contents each year against theft and other potential (but unlikely) disasters, we should put in place an agreement that dictates what will happen in the event any one or more of these events take place.

How does a BSA work?

In its simplest form, a business succession agreement (also known as a buy-sell agreement) (BSA) deals with the 'involuntary' exit of a principal in a business that has two or more principals in the following way:

- Upon the happening of an agreed event (for example, the death of a principal), the estate of the principal is granted a put option by the surviving principal in respect of its equity in the business, and the surviving principal is, at the same time, granted a call option over the equity of the affected principal's equity in the business.
- The agreement sets out timeframes within which those options may be exercised by both parties and sets a value (or valuation methodology) to determine the price to be paid for the transfer of the affected principal's equity in the business to the remaining principal.
- Assuming one of the parties exercises its option, the family of the deceased principal will have received a fair sum for the equity in the business without having to continue to work in the business, and the remaining principal owns 100 percent of the business and is able to continue to operate as a sole principal without interference from the family or executors of his/her former business partner.
- The purchase price payable under the options is normally funded (wholly or partly) by way of insurance policy.

A BSA can be used for all types of business interests including shares in a company, partnership interests and units in a unit trust.

Tips and traps

While the purpose of a BSA is relatively simple, the following areas can cause potentially significant problems if not handled correctly:

- Mandatory versus discretionary agreements

A BSA should never force a party to either buy or sell upon the happening of a particular event. The agreement should only ever include an option in favour of one or both of the parties. The reason being that if the BSA creates an obligation on one party to acquire an interest upon the happening of the event, then a CGT and stamp duty liability may be triggered on the signing of the agreement as opposed to the happening of the event (e.g., death).

- Determination of value

The BSA needs to determine a means by which the value of a principal's equity in the business is determined. This can be done in a variety of ways including the following:

- (a) The agreement may set out a methodology for agreeing the price at which equity will be transferred. Some agreements will actually fix a dollar sum with the intention that parties will revisit this figure regularly. However if the valuation is not regularly revised, then it may produce an unfair result for one of the parties when the agreement is triggered.
- (b) The agreement sets out a formula for calculating the price (such as a multiple of earnings). If this method is adopted, then it is important to ensure the methodology remains appropriate over the course of time.
- (c) The agreement provides for the business to be valued at the appropriate time by an independent party. The agreement should allow for the appointment of a valuer by an independent person in case the parties cannot agree on a valuer. It is important to consider whether the valuation of the business should be in respect of the value of the business before or after the event which triggers the option. Usually it is most appropriate for the value to take into account the value of the business before the trigger event.

- Balance of purchase price

A BSA is usually funded by insurance. Therefore it is very important to regularly review the value of the business against the level of insurance in place to determine whether it is adequate. If there is a deficit between the proceeds of insurance and the purchase price, then the BSA should set out the terms on which the balance must be paid.

- Ownership of insurance

It is important to consider the tax, estate planning and bankruptcy implications of insurance ownership, particularly in the context of BSAs. Inappropriate ownership of insurance policies can, at worst, render the entire agreement ineffective, or at least result in the payment of unnecessary tax.

- Execution of BSA

Parties must be careful if the BSA is signed within 12 months of acquiring an asset. This is because tax law provides there will be no entitlement to a CGT discount if the agreement was signed within 12 months of acquiring the asset. However with careful drafting, the CGT discount can be preserved even if the agreement is signed within 12 months of acquiring the asset.

Advantages

The advantages of a BSA are numerous:

- The business partners are not forced into business with an inexperienced member of the deceased's family.
- There is adequate funding in place to ensure the spouse and children of the deceased/incapacitated partner can maintain their standard of living.
- The possibility of conflict among the remaining business partners or the remaining business partners and the widow/widower is significantly reduced.
- There is an agreed mechanism in place for valuing the business if a business partner is forced to sell his/her share unexpectedly to ensure the equal and fair treatment of all parties.

For more detailed information on business succession see our paper titled, "Unlocking the value of your business: succession planning".

Case study—Business succession gone wrong

This case study involves a partnership of three doctors, a father (age 60), son (age 35) and an unrelated third party (age 42). Rather than documenting an agreement, they relied on a handshake agreement because they were friends as well as business partners. Their agreement was that they would self insure for \$1 million and that if one of them should die, then this would be enough to support their families and the business would be transferred to the remaining partners. They agreed on the \$1 million amount 5 years prior to the 42 year old independent dying suddenly.

The wife of the deceased received the proceeds (\$1 million) from the insurance policy and the father and son honoured their handshake agreement and continued to run the practice as 50/50 partners. The deceased's spouse then promptly put her hand out for her one third share of the business which was now estimated to be worth \$1.5 million. Because there was no written agreement in place, there was nothing to stop her making such a claim. After five years of litigation, the matter was settled for somewhere between \$600K and \$700K. By this stage the father was age 65 and retired, and the son was left to run the practice on his own.

The lawyers drew up a deed which all parties duly executed. Immediately after the deed of settlement was signed, the lawyer for the deceased spouse served a claim for undistributed profits from the service trust which the practice had used to stream profits from the professional partnership. The professional advisers had failed to look at the business in totality and completely missed the existence of the service trust.

The service trust was a unit trust of which the deceased was the holder of one unit which passed to his wife on his death. Ever since his death, the accountant for the partnership had been distributing all the profits to the surviving two unit holders, despite the fact the deceased's spouse was entitled to a one-third distribution from that trust. The claim was brought for a one-third share of the profits during the past 5 or 6 years of litigation.

This unfortunate course of events could have been avoided if the parties had reduced their handshake to writing and put adequate funding in place.

**McMahon Clarke Legal specialises in estate planning and wealth management for private clients.
We work with you to develop an estate plan that takes into account your personal circumstances.**

For more information contact a member of our private client team on 07 3831 8999 or info@mcmahonclarke.com