

THE ART OF BUSINESS SUCCESSION

Part three: personal wealth mangement

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PERSONAL WEALTH MANAGEMENT

Business succession planning is not all about the business. The process must also account for the preservation of the individual welfare and personal financial security of the business owners and their families. In addition to dealing with business issues, owners must consider the effect the business succession plan will have on their personal financial situation and the financial condition of the other key stakeholders.

Careful consideration should be given to non-company issues such as individual retirement goal setting, cash flow planning, tax strategies, life insurance planning and investment portfolio tactics. An important goal often not given enough consideration by business owners is the plan for themselves and their life partners to achieve a 'great life' both during and after the succession planning process has been finalised and implemented. Whilst the definition of a 'great life' will be different for every person, the methodology to plan to achieve it is not, and the methodology is as thorough as the planning necessary for the business succession itself. This part of the goal articulation process for the business owner can be the key that unlocks the whole succession process, by allowing the business owner to see a life beyond a full-time role in the business.

RETIREMENT PLANNING

Not infrequently, business owners anticipate reliance on cash flow (or, in some cases, sales proceeds) from their business to fuel retirement-related living expenses. When this is the case, the retiring owner needs to ensure that the source of cash flow is adequate and protected. Retirement planning for closely-held business owners can be especially challenging, as a closely-held business owner's retirement plan is generally interrelated to other critical issues like management grooming and development, tax planning, shares transfer techniques, valuation and corporate finance.



RETIREMENT PLANNING

Goal setting is the key starting point for the deliberation of a retirement strategy:

- What is the business owner's vision – retirement or 'creative' retirement?
- Does the owner want to reduce the amount of time spent at work, to remain active in the management of the business or to carve out a new role?
- What are the goals and the sort of retirement lifestyle envisioned?
- How much money and time will it take to plan to achieve these goals and how much income and periodic capital payments will this lifestyle realistically require?
- Does the business owner have sufficient wealth to fund the proposed lifestyle? If not, what are the options available? Does the wealth of the business owner need to be restructured to provide the most efficient way of funding the new lifestyle? In addition, what effect will inflation or the performance of the share market have on the plan, and do the current investments sit comfortably with the business owner's independently-assessed risk profile?
- What other issues are likely to affect retirement cash flow needs such as health and life expectancy of the owner and the owner's spouse, family obligations, (e.g. Care for disabled relatives), tax effective estate plans or separately identified tax objectives?

Future retirees should spend time with a professional who is experienced in identifying and setting value-based goals to achieve a 'great life' (rather than simply concentrating on financial goals) by envisioning their specific desires in relation to their life to come. This may lead to recognition of various other needs, e.g. financing large purchases such as a holiday home or boat, continuation of study, philanthropic activities that may require the investment of time rather than money or both. Many business owners will also want to guarantee the financial security of their spouse. In addition, there may be concerns about coordination of retirement plans with the assumption of the company's successor. Some individuals may decide that they don't plan to retire 'completely', preferring instead to work indefinitely in some other capacity. Others may choose to fund education for their grandchildren. Whatever your plans, formalising creative retirement goals and the application of a timetable for achieving those goals will prove an invaluable exercise. Going through this process will enable you to be realistic in the plans you choose to follow. A future retiree without a clear picture of potential requirements increases the chances of falling short of vital retirement needs. Some individuals will arrive at retirement cash flow levels that are far less than their pre-retirement annual expenses, while others may actually plan to increase their spending after retirement. The important thing is to understand and to quantify those desires in detail to ensure that you have the creative retirement that you desire.

RETIREMENT PLANNING

After the critical goal setting phase is completed, pertinent financial and other data should be compiled and goals analysed regarding realistic achievability. Specific strategies and alternatives should be developed and documented with a special 'action plan' implemented to ensure the overall plan comes to life. This plan should be consistent and coordinated with all other relevant elements of the business owner's succession planning. Given the tax advantages afforded by superannuation, it is essential that any strategy takes into account the use of superannuation, both as a savings vehicle and for providing tax efficient income streams in retirement. Superannuation can even play an important role in estate planning and it is important that these aspects are considered carefully with an appropriately qualified advisor.

Once the retirement plan is 'up and running', it should be reviewed periodically to ensure that everything is moving according to plan. These periodic reviews should not be overlooked as they will provide ongoing opportunities to address inevitable changes in personal and financial circumstances. In this way, the financial planning process can serve as a critical tool toward the development of strategies to enhance the retiree's financial security and to build a plan based on the individual's retirement goals.

TAXES

Often closely-held business owners accumulate net worth in their business through goodwill that can be subject to tax on sale. For this reason, all business owners must look at their tax exposure. Owners of closely-held businesses often have no real sense of the value of their company. As the wealth of closely-held business owners is typically tied up in illiquid assets, the imposition of the tax may force heirs to sell the business in order to pay the tax.

Therefore, as part of your considerations, you should talk to an appropriately qualified financial advisor to determine the value of your current estate and for assistance in projecting its future value. Prior to that, you should determine the extent of any tax exposure in order to prepare the way for further succession planning. When developing an effective tax plan, business owners must also consider other elements of succession planning such as developing and motivating management talent, transferring ownership, retaining key employees, dealing fairly with family members (who may or may not be actively employed in the business), retirement planning, cash flow and investment portfolio strategies. As there are many techniques to minimise tax, it is often suggested this is an 'optional' tax and only those who fail to plan actually pay. However, every case has individual considerations and although tax planning is an essential and integral component of a succession plan, tax planning does not equate to succession planning. Nonetheless, tax planning is always a most important component of comprehensive succession planning. Inadequately considered, taxes have the potential to threaten many businesses – but creative strategies DO exist to legitimately reduce tax.

TAXES

Using trusts in tax planning

Trusts are used for a variety of purposes. The flexibility of trusts is perhaps the major reason that they are so widely used in tax planning. Trusts can be created and funded during a lifetime (inter vivos trusts) or they can be created by the terms of the will (testamentary trusts – it is important to note that this type of trust is only created when someone dies, there is no compliance, etc until it comes into place). The terms of a trust may allow it to be changed or even revoked or the terms of the trust may be fixed or irrevocable at the date of creation. Several of the primary purposes for using trusts in tax and financial planning are summarised below.

Managing assets

The responsibility of making investment decisions and maintaining adequate records can be transferred to either a corporate or an individual trustee.

Protecting assets

In certain situations, a properly drafted trust can protect the assets in a trust from creditors of a beneficiary. In addition, the assets may be protected from a spouse in the event of the divorce of the beneficiary.

Providing privacy

The assets, terms and conditions of a trust are generally not subject to public inspection.

Avoiding probate

The assets that are held in a trust created and funded during the grantor's lifetime are controlled by the terms of the trust, not by the terms of probate.



Providing for multiple beneficiaries

A trust can be created for the benefit of multiple beneficiaries and can allow the trustee to use discretion in making distributions in a tax effective manner.

Providing for special needs

A beneficiary may have special needs relating to education, health, and so on. A trust can be used to address those special needs.

Minimisation of tax

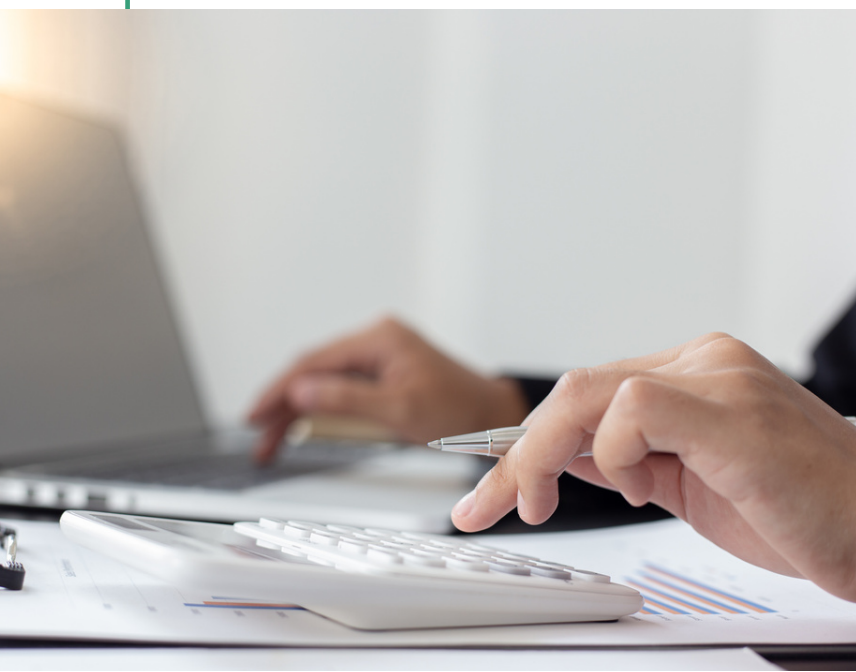
A trust allows income and capital gains to be flowed through to beneficiaries and, with astute planning, legitimate tax reduction can be achieved.

TAXES

You may implement a trust arrangement during your lifetime or under the terms of your will. In addition, you can establish a trust during your life to begin operation upon your death. A trust established during your lifetime (inter vivos) can be used with respect to tax planning for certain types of assets.

In creating a trust, particular attention should be paid to the choice of a trustee – the individual or company that will be responsible for the management, investment and distribution of funds. The trustee is also the legal owner of all assets of the trust and holds those assets on behalf of the beneficiaries pursuant to the terms of the trust deed. Because the trustee is personally liable to lenders and creditors and can be sued by beneficiaries for any loss or damage suffered as a result of a breach of trust, it is usual these days for the trustee to be a \$2 company rather than a natural person. In this way, only trust assets (and not personal assets other than the \$2 share capital of the corporate trustee) are put at risk.

The trust deed is the memorandum that governs the operations of the trust. The deed usually identifies the primary and general beneficiaries of the trust, defines the duties, powers, discretions and liabilities of the trustee, provides for the removal and appointment of the trustee, indicates how income and capital will be distributed among the beneficiaries and designates the trust property. As a trust deed can be difficult to alter, it is advisable to include a variation clause to incorporate flexibility in the trust deed to cope with future changes in the law as well as possible reorganisation of the family affairs. Most trust deeds name one or more individuals or corporations as the appointor/s who have the power to replace the trustee. As the appointor is in a powerful position in relation to a family trust, careful consideration should be given to the identity of the appointor and to make sure that a suitable person becomes appointed if the appointor named in the trust deed dies, becomes incapacitated or retires.



LIFE INSURANCE

Life insurance is the most common remedy to tax exposure as it can provide instant liquidity on a tax-free basis at the precise point when the cash is needed (upon the death of the insured).

Life insurance planning

Life insurance is a basic tool to manage the risk of loss and can effectively provide income replacement for a family or business upon the death of a wage earner or key employee. For closely-held business owners, proceeds from life insurance policies may be used to purchase the shares of a deceased shareholder of the company in order to facilitate the transfer of the business from one generation to the next. Life insurance proceeds may also be used to pay taxes.

Life insurance is almost always a consideration when developing a succession plan, because as new succession strategies are developed, old insurance needs may become obsolete, while new insurance needs may arise. The following discussion of various insurance strategies illustrates some of the different roles that life insurance may play in succession planning.

INCOME REPLACEMENT

The primary reason that most people buy life insurance is as replacement for income streams from wage earners for their families. This need is sometimes overlooked by business owners planning for succession. This is because many owners plan to bequeath the business to their family members and assume the family members will continue to reap the same cash flow from the business after their death. This reasoning does not account for the fact the family will lose the income stream from the deceased's salary. That salary must now go to someone else performing the duties of the deceased. If the replacement employee is not a family member, the cash flow provided by that salary is no longer family income. As is often the case with closely-held businesses, the CEO's salary may constitute most of the cash flow for the family's annual living expenses.



INCOME REPLACEMENT

Key person insurance

Key person insurance provides closely-held businesses with protection if one of the key employees dies. The business generally makes the premium payments and is the beneficiary of the policy. Key person insurance policies should be maintained in suitable amounts for the lives of all family members in a closely-held business who are involved in day-to-day management activities, as well as selected key non-family executives.

The sudden and unexpected removal of a key executive from his/her position in a closely-held business can have a devastating effect on operations, not to mention an emotional impact on everyone in the company. Emotions may affect the swiftness of the response by company management in replacing the lost executive, especially in the case of a family business. Many closely-held businesses have not planned for such a hardship and may not have a suitable replacement ready. It may require the company to recruit new candidates from outside the company. The demand for talented executives is very competitive. It may take months, even years, to find a replacement who fits.

When the company patriarch or matriarch dies unexpectedly, the impact is magnified. Loyal customers and suppliers may re-evaluate their relationship with the company. Special relationships and business deals that were based on personal relationships with the now deceased leader of the business may be retracted.

Shareholders may become concerned about the security of their investment in the company. Employees may worry about the security of their jobs. Bankers may become concerned about the ability of the company to sustain loan covenants without the leader of the business in place and may be more cautious in dealing with the company going forward.

All of these difficulties will affect business cash flow. Key person insurance proceeds will help the company through the transition process. Bank loans can be paid down. A stronger balance sheet (with cash reserves and less debt) will help creditors, customers, shareholders and employees feel more secure in the viability of the company. If sales decline temporarily, the company will have excess cash reserves to continue through the rough times. Finally, the insurance proceeds may be used to help recruit and train the deceased executive's successor.



INCOME REPLACEMENT

Funding a buy-sell agreement

The death of a closely-held business owner is often a triggering event in a company's buy-sell agreement that mandates the purchase of the deceased owner's shares by the company or the other shareholders. Life insurance is commonly used as the funding source to pay for such a purchase. Typically, buy-sell agreements are designed as either redemption agreements (the company buys the shares from the deceased shareholder) or cross-purchase agreements (the other shareholders buy the shares from the deceased shareholder). If the buy-sell calls for a redemption, the company will purchase adequate life insurance coverage on the lives of all the shareholders. If one of the shareholders dies, the proceeds from the life insurance policy are used by the company to purchase the shares from the deceased shareholder's estate. If the buy-sell agreement calls for a cross-purchase, all of the shareholders will buy insurance policies on the lives of all the other shareholders. In the event of the death of any one of the shareholders, the surviving shareholders will use the proceeds from the life insurance to buy the shares personally from the deceased shareholder's estate.

INVESTMENT STRATEGY

Business owners face special challenges when it comes to managing family wealth. Due to the demands on time and energy required to stay on top of business operations, many business owners find little opportunity for personal investment management. The demands of managing company operations are so great that little time is spent reviewing and monitoring incremental investment performance. Very busy business owners may simply defer capital investment decisions to a broker or money manager. That individual, while professional and committed to serve, may also be influenced by corporate pressures to sell certain investments or by personal intent on commission. As a result, an investment portfolio may not perform to potential or the execution of the investment strategy may not align with the family's goals or those of the business.

Investment diversity also presents a special challenge for closely-held business owners. Growing a business requires capital. During periods of growth, many business owners answer part of the need for capital by constantly reinvesting profits back into the company. As a result, the accumulation of a large diversified personal investment portfolio may not materialise, so investment planning ends up relatively low on the owner's list of priorities.

Succession planning, however, may change everything. The result may be that the founder, who for decades has concentrated on managing and growing the business, must suddenly change focus and worry about managing a large amount of liquid wealth. While some individuals approach the management of their personal wealth as their retirement 'vocation', others are better served by the acquisition of professional investment advice. In such instances, the founder's advisory professional services firm can play an invaluable role.

INVESTMENT STRATEGY

Managing wealth should be an integral part of any comprehensive succession planning process. To anticipate and plan for future needs successfully, investment advisors must understand their clients':

- Overall life goals and objectives
- Need to marry investment goals to life goals
- Personal risk tolerance
- Level of knowledge relating to investing
- Current investment strategy
- Current investment portfolio.

To offer the best counsel in relation to succession issues, investment advisors must also have a clear command of the following issues:

- The tax ramifications of the technical aspects of the succession plan
- The practical and financial ramifications of the technical nuances of the succession plan
- Short-term and long-term individual liquidity needs
- Possible future business concerns, such as financing or capital obligations: even after an exit strategy has been executed and ownership passed to the next generation, the founder may find that the new generation of owners will require transitional assistance with bank arrangements or other business relationships that may involve some form of financial pledge from the founder
- Human nature, especially when dealing with a family business: estate planning and birthright or fairness issues between heirs working in the business and heirs working outside the business can complicate the investment planning process
- The founder's retirement plan
- The founder's will
- The founder's insurance needs
- The founder's income tax and capital gains tax situation.



INVESTMENT STRATEGY

This information may have a direct impact on investment decisions, as misunderstood tax issues or unanticipated cash needs will certainly derail investment strategies. Based on the information referred to above, the investment-consulting process will generally entail four basic steps.

1. **Assessment:** the investment advisor will assess the current portfolio, investment strategy and risk tolerance, and provide education on investment principles and on how to relate an investment plan to specific financial goals. Furthermore, the investment-advisory specialist will work to understand and account for all of the elements of the comprehensive succession plan when assessing the investment needs of the business owner
2. **Analysis and recommendations:** the investment advisor will develop asset-allocation models and assist in the drafting of an investment-policy statement
3. **Implementation:** the investment advisor will provide information on fund managers, including identification of fund managers who are compatible with the investment policy statement developed in the analysis and recommendation phase. Of course the investor will retain responsibility for the final decision regarding fund manager selection
4. **Monitoring:** on a periodic basis, detailed summaries of portfolio holdings and transactions, portfolio performance reports and ongoing supervision of investment policy should be provided.

An investment advisor who understands all of the components of the succession plan can better account for income tax complications, retirement needs or other special cash requirements. The seamless coordination of an investment advisor who is independent, tax sensitive, and 'in the loop' with regard to the succession plan is most desirable.

FAMILY OFFICES

Successful closely-held and family businesses typically evolve over generations from entrepreneurial start-up organisations, through expansion, ultimately into large, professionally-managed corporations. As a closely-held company grows, it needs to develop improved management processes and to hire experienced professionals. Skilled professional managers help the owners with strategic direction/growth, finance, accounting, tax, human resources, information technology, operations, sales and research and development. As a business evolves, the amount of involvement next-generation owners have in the day-to-day operations may decrease. As the branches of the family tree spread, more family members inherit ownership and the number of company shareholders may increase. In just two generations, the number of shareholders in a closely-held company can easily grow from two to thirty. From a succession planning standpoint, many of these new owners may not have meaningful management roles. They may serve on the board of directors but choose to leave the daily management of the business to the company executives. They may pursue other vocations or focus their life's work on philanthropic activities.

FAMILY OFFICES

Often, the grandchildren and great-grandchildren of the company founder find themselves owners of a highly profitable, professionally-run organisation that is generating significant profits for the family owners. In some cases, the company is acquired or goes public and the illiquid privately-owned shares are transformed into cash or publicly-traded shares. If this occurs, the family members may have a lot of wealth to manage. At this point, the family needs to consider the establishment of a family office. A family office is a professionally managed financial organisation. The family office will often employ a management team including a CEO, Chief Financial Officer (CFO), a Chief Investment Officer (CIO), and a staff of accountants and administrative assistants. Their primary role is to manage family affairs and wealth in a professional manner. Governance structures, like a board of directors or family council, are populated by the family members. The family office reports to the family board. The family board or family council will meet regularly and oversee family office activities. At these meetings, family members receive reports from the family office management regarding the family wealth and other family-sponsored activities. In board meetings, family members typically discuss a wide variety of issues such as investment strategy, charitable activities, performance of family office staff, purchases or sales of significant family assets, estate planning, family publicity and privacy issues, or any number of other topics that may be important to the family.

The purpose of the family office is to protect family wealth and promote harmony. It does so by applying sound business structures and theory to the management of the family's personal wealth. As generations pass, more and more individuals become stewards of the family wealth and tradition. The more stewards, the higher the likelihood for conflict, or mismanagement of wealth. When properly organised and staffed, a family office replaces emotional, subjective, and historical processes with rational, objective, and forward-looking processes. The use of skilled professionals who devote their full attention to the protection and growth of family wealth and who are accountable to family members can be very smart planning. They also free up family members to focus on other areas that interest them.

The family office also centralises and manages the often tedious and overwhelming administrative functions of the family, including the reconciliation of bank/investment statements, payment of bills and taxes, preparation of financial statements, executing investment strategies, dealing with insurance needs, managing tax compliance for all family members and related entities, maintaining confidential records in a central location, and anticipating possible future administrative needs. Family offices may also provide other services, (e.g. coordinating travel plans for family meetings) as determined by the family board.

A closely-held business owner who anticipates continued ownership over future generations should consider the role a family office might play in the succession plan. Often the policies and structures an owner puts in place today, such as the establishment of a family office, lay the foundation for an affluent and harmonious lifestyle and preserved family legacy for generations to come.



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