FUNDED BUSINESS SUCCESSION DEEDS:
IMPORTANT FOR YOU, YOUR BUSINESS PARTNER(S) AND YOUR RESPECTIVE FAMILIES

Introduction

A funded Business Succession Deed operates in conjunction with various types of insurance policy. Its function is to overcome so far as possible the financial detriment to a business (the **Business**) that can be caused by the death (and sometimes various other conditions such as the permanent incapacity) of a person (a **Key Person**) that is integral to the Business.

It is not uncommon for a Business to fail or suffer significant loss if a Key Person dies or becomes permanently incapacitated (the entity that owns a Key Person's interest in the Business is an **Owner** and an Owner with an affected Key Person is referred to as the **Terminating Owner**). In addition to the Business being affected by the loss of a Key Person, the demise of that Key Person will test the ownership structure of the Business. This is because the continuing owners (the **Continuing Owners**) do not generally have the financial means to purchase the Terminating Owner's interest in the Business. Also, it is not uncommon that the testamentary beneficiaries of the affected Key Person do not wish to participate in the Business. Rather, their preference may be to realise cash for their part of the Business. If the Continuing Owners do not have the means to purchase or finance the purchase of that portion of the Business from the Terminating Owner (or the executors of the estate), the only means to realise cash would be an arm's length sale of a part of the Business to a third party. This is generally not the preference of the Continuing Owners. Also, it is usually difficult to realise the true value if only a part of a Business is sold and in rushed circumstances (as can occur where a Key Person is affected by death or permanent incapacity).

General Operation

A funded Business Succession Deed generally provides that, upon the death (or, if desired, the permanent incapacity, trauma or other event, each of which is described as an **Option Event**) of a Key Person, the Continuing Owners have the obligation to purchase (and the Terminating Owner has the obligation to sell), the Terminating Owner's interest in the Business. This is achieved by the grant by each Owner to the other of options to buy and sell (known as a **Call Option** and a **Put Option**) each other's interests in the Business upon the occurrence of an Option Event.

Upon exercise of an option, a Terminating Owner must transfer its interest in the Business to the Continuing Owner (or its nominee) for a purchase price (the **Purchase Price**). The Purchase Price should reflect the value of the Business from time to time.

Where the owner (the **Beneficial Owner**) of the insurance policy is the affected Key Person (i.e. the insured person and the owner of the policy are both the same person), the receipt by that person (or, more likely, the executor of his estate) of the insurance proceeds is deemed to comprise payment of the Purchase Price by the Continuing Owners.

In this way, the Terminating Owner's estate monetises its interest in the Business and the Continuing Owners take over the Terminating Owner's interest in the Business.

This is consistent with most people's wishes that the Business ends up with the continuing business owners, and the cash ends up with the beneficiaries of the deceased business owner.

Alternatives

There are, of course, a number of permutations and alternatives that can operate in this area.

For example:

1 If the Purchase Price is more than the insurance proceeds, the Continuing Owners may have to make instalment payments to the Continuing Owners to satisfy the full Purchase Price.

2 The proceeds of insurance can be applied for different purposes. Typically, the insurance proceeds would be applied for the purpose of funding all or part of the Purchase Price for an Owner's equity in the Business – this is the application explained above. In addition, however, the proceeds of an insurance policy could be applied as follows:

   (a) for the purpose of enabling the Business to meet the revenue costs of continuing the work currently performed by the Insured;

   (b) for the purpose of enabling the Beneficial Owner to meet its debts to persons or entities who are not parties to the business succession arrangements;

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(c) for the purpose of enabling the Beneficial Owner to assist in securing the release of an affected Key Person from guarantees he or she may have provided;

(d) for the purpose of enabling the Beneficial Owner to meet its debts to persons or entities who are associates of any of the parties to the Deed; and

(e) for the purpose of enabling the Beneficial Owner to meet the personal estate planning and capital gains and other taxation needs of the insured person, their family, estates or related entities.

Your financial planner and you should discuss your circumstances and whether it is desirable to arrange a level of insurance for any of these other purposes.

Insurance can, of course, cover different types of Option Events. For example, in addition to death, insurance can be arranged for total and permanent disability, trauma and other similar events. Again, you should discuss your circumstances and requirements with your financial planner.

Where an Owner is affected by death or another Option Event, you may wish for that Owner's salary to continue to be paid for a period of time or for a dividend to be paid by the Business. This can, of course, be of assistance to the affected Key Person's dependants.

Your Business Succession Deed can be tailored to reflect any of these particular arrangements.

Considerations

A number of important considerations apply to funded business succession arrangements.

For example:

1 It is critical that the level of insurance is adequate given the value of the Business. If a Key Person is under-insured, that person's estate and testamentary beneficiary is likely to be burdened with having to finance the shortfall (i.e. the value of the Business less the value of the insurance proceeds) internally or from borrowings.

2 It is important that the level of insurance be monitored regularly and increased if the value of the Business grows. An obligation to review the Purchase Price from time to time is typically included in a Business Succession Deed.

3 Issues can arise if an affected Key Person does not have valid testamentary arrangements in place. Accordingly, the Business Succession Deed should contain an acknowledgment by each Key Person that their testamentary arrangements are up to date and effective. If this is not the case, each Key Person should address their personal succession arrangements concurrently with making the Business Succession Deed.

Taxation

There are a number of important capital gains tax issues to be managed when establishing funding business succession arrangements and the insurance policies and ownership of those policies for these arrangements. If this ownership is not structured correctly, the insurance proceeds can even be taxable! This is a complicated area and expert advice should be obtained.

If you would like to know more about Business Succession Deeds, please contact us.

About Us

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