The Importance of Estate Planning for Family Businesses

Dr Denis Jaffe, Professor of Organisational Systems, Saybrook Graduate School, San Francisco, defines family businesses as existing where ‘… two or more family members work in the business and share or expect to share ownership, and intend to pass ownership on to the next generation’. (Jaffe, 2010)

According to the KPMG and Family Business Australia: Survey of Family Businesses published last year, family businesses account for 70% of all Australian businesses.

The typical family business cited in this survey is one in which the ownership and management rests solely or largely with one or more members of a single family. While single-family involvement is the dominant family business paradigm, there is considerable variation in business structures and styles, and the business enterprise may consist of two or more families who share decision-making responsibilities.(KPMG, 2009)

Most family businesses are relatively small affairs, but there are some privately-held family companies and listed public companies controlled or dominated by family shareholders — including a few very large and successful ones such as News Corporation — which are major players in key sectors of the Australian economy.

According to Michael Perkins, Special Counsel, Diamond Conway, and Lecturer in Estate Planning, University of Technology, Sydney, family businesses can have a variety of arrangements: ‘A family business … [is either controlled by] a husband and wife, or a father and son, or it can also be a collection of families … It can also be through successful business succession via children, grandchildren, nieces, nephews and cousins …’ Perkins said.

Unfortunately, the research undertaken by Family Businesses Australia and KPMG also shows that well over half (65%) of family business don’t survive into the second generation, and around 20% fail when the business passes to the third generation.

This can mainly be due to the fact that family-run businesses can be complicated, as members need to balance the management and the day-to-day business matters with the social and emotional aspects that are inherent within any family.

Further complications also arise with deciding who will inherit the family’s wealth, and importantly, who has the family’s legacy at heart when it comes to managing business operations. The risk tolerance of the heirs, wealth preservation priorities of the current wealth holders and pattern of property ownership in the family all interact to generate the final wealth management and transfer plan for the client and their successors. Jaffe said that: ‘Issues of inheritance, sibling recommendation, commitment, capability of the next generation, mingle with the pressures of all businesses facing the demands of a global marketplace and the challenges of growth.’ (Jaffe, 2010) An ageing population and family rivalries can also make it difficult to recruit the next generation of ownership and management.

All of these factors can, however, be mediated and resolved through effective estate planning.
Financial advisers, together with other key professionals such as lawyers, accountants, family business advisers and tax advisers, can use estate planning tools such as buy/sell agreements, trust structures and Wills to resolve complications and ensure that clarity and unity exist for the client and their successors with regard to business succession.

**Estate planning considerations**
When undertaken properly, estate planning can ensure that a family-run business and the assets within that business are transferred to the intended people at the appropriate time. Alternatively, it may also focus the client on the commercial difficulties in leaving the management of the business to a person not competent to manage it as the client would have done. This may result in planning for a sale of the business. Similarly, dependence of the client on wealth extracted from the business to fund their retirement strategy may also result in an early sale of the business. Indeed, the question must be asked; can the client afford to not sell the business for maximum value within a reasonable time from now and thus risk not having access to that capital as they age?

Estate planning for family businesses involves a complete consideration of assets and liabilities, ownership structures and insurances to ensure that the transfer and control of assets are managed to maximise the benefit to the deceased’s estate and beneficiaries.

John Stinson, Partner, Diamond Conway Lawyers, and Accredited Specialist in Wills and Estates and Business Law, said that when it comes to family-owned businesses, estate planning will also involve an assessment of asset value — specifically, what a person’s assets are today and what they are likely to be worth in the future, such as in retirement or at death. ‘… a strategy can be put in place and documented to deal with either structuring the ownership of those assets today and/or working out how they will be passed on in the future and managed … [to achieve the desired outcomes of the family business].’

When making planning decisions on asset distribution, either before or after death, consideration also needs to be given to the correct and most tax-effective financial structures and arrangements to protect a family's interests, now and in the future. The most common forms of asset ownership for family-run businesses include personal ownership, where assets are:
- dealt with in a Will
- held within a family trust
- held within superannuation
- held within companies.

**Asset ownership considerations**
There can often be nothing worse than situations where assets have been dealt with by a Will, only for the executor and beneficiaries to discover that the Will-maker, that is, the testator, actually does not own the assets.

Stinson said he sees this situation often and it is one area that financial advisers can easily address by seeking clarification on asset ownership. ‘… you can start to get a clue from looking at the balance sheet for the family business, because they should record all of the assets in the business’, Stinson said.

Obtaining further advice from an accountant or lawyer can be highly beneficial where asset ownership needs clarifying. External advisers or departments can also be engaged to conduct title searches to further determine asset ownership.
Case Study 1: Determining asset ownership

Consider the case of two separate families who have 50/50 ownership of shares in a very successful kitchen manufacturing business, Blitzin’ Kitchens. The two families consist of two brothers, who are the key to the success of the business, and their respective wives. The two couples own the family business through a private company structure. The couples decide to employ the services of a financial adviser, as they want to make arrangements so that if one of them were to suffer incapacity or die, the business could continue and be completely taken over by the other family.

They also want their arrangements to state that if one of the brothers were to die or become incapacitated, that the respective brother or widow would receive a fair value for their family’s share of the business from the other family. The financial adviser believes a buy/sell agreement, with two life insurance policies for the brothers, is the correct estate planning approach and he contacts the lawyer for the families.

However, the lawyer later discovers that the financial information he has been given by the adviser, does not include any details about the factory where Blitzin’ Kitchens makes all of their kitchens.

Upon further investigation, the lawyer notices that the company’s balance sheet shows that there is a large debt outstanding to another company with a very similar family name. The lawyer later discovers that the name is that of the trustee of a superannuation fund, into which both families contribute and which actually owns the factory in question.

In this case, had the lawyer done what the financial adviser requested and put a buy/sell agreement in place for Blitzin’ Kitchens, and one of the brothers were to die, his family would have received an insurance payout, reflecting the value of the business and the factory, while the surviving brother would have been left with half the business, but not the factory to continue the business.

The key message here is that legal and/or accounting advice is crucial in estate planning, especially when it concerns asset ownership identification and the formulation of buy/sell agreements and their associated funding strategies.

Buy/sell agreements

One of the most effective ways for a business to be transferred on the death or incapacity of a business owner is through a buy/sell agreement. While another method is to gift the business in a Will, this is usually not the most preferred option because Wills can be contested and unintended people can end up with a share of the business, as well as other unforeseen outcomes.

If a buy/sell agreement is in place, it will take precedence over a Will, because the business will be transferred pursuant to the contract.

A buy/sell agreement is a contract usually entered into between business partners, which enables the surviving partners to buy the other out should an unexpected event occur, such as death, incapacity or even bankruptcy.

Buy/sell agreements are often linked to an insurance policy. One business partner may hold an insurance policy on the other’s life. Life insurance can provide the surviving partner with the money to be able to buy out the other partner. Alternatively, each partner may have a policy on their own life, the proceeds being taken in lieu of, or as part payment of their share of the business. In both cases, the premiums will be paid from the business. Unfortunately,
some businesses think that simply having an insurance policy in place is enough. However, this is not the case, and buy/sell agreements should be strongly encouraged.

**Case Study 2: Life insurance dilemmas**

Stinson said that many years ago he was asked to provide legal advice in relation to events that transpired following the liquidation of a business involving three equal shareholders, including a married couple and a totally unrelated third party.

The trio wanted to cover the possibility of one of them dying. Each took out a life insurance policy on their own life, with the object being that if one of them were to die, the proceeds would be passed onto the estate of the person who had died, and the other two shareholders could take over the shares of the deceased, without having to raise money or liquidate the company. ‘The problem was that … the life insurance was only part of the [necessary] package. Without the necessary background documents [a buy/sell agreement] in place, whereby each of those owners said “if I die, I’ll take the insurance instead of getting paid out and I will transfer my share to you” — without that in place, the result they wanted did not follow’, Stinson said.

Months passed and a number of events occurred including, the couple divorcing and the husband moving to South Australia, which has different inheritance laws from New South Wales, where the other two were based. Sadly, the husband died. His insurance policy paid out to his estate, which along with all his other estate assets, went to his brothers. The brothers also inherited his share in the company — it did not go to the other two owners.

Buy/sell agreements can become complicated when the valuation of assets is concerned. For a buy/sell agreement to be effective, it must identify the owner of the interest being disposed of and the type of interest disposed of (shares, units, partnership). The agreement must also specify who is to acquire the interest (business partners, key personnel).

Stinson said that a common financial planning error is for life insurance to be sold to business owners on the basis that the life proceeds would be adequate to buy out the other owner’s interests. ‘If the business has trebled in value, they [the client] do not want to be paid out a figure which is equal to yesterday’s value …’ Stinson said.

Stinson adds that financial advisers need to alert their clients to the commercial reality of valuation and ensure that professional advice is being sought on asset valuation annually and that insurances are also reviewed. ‘The best way … is for the clients to pre-agree on the pay-out figure on an annual basis … or simply say it will have to be valued by some expert valuer at the relevant time and one has to work out a method of choosing the appropriate valuer, which also would depend on the business,’ Stinson said.

The relationship between the value of the business, the value of the estate and how much a business owner will need to fund their retirement are also important considerations for a financial adviser.

**Case Study 3: Value and retirement planning**

Bill is a 62-year-old business owner who wants to pass the family business over to his son, Jerry. Bill claims to be a ‘$20 million man’ with his assets consisting of $6 million worth of homes, cars, boats and a beach house, plus the family business, which specialises in commercial garbage removal and has a current market value of $14 million, representing 70% of Bill’s total wealth.

One day, Bill meets with his lawyer to discuss a business succession plan for Jerry to take over as Managing Director and for himself to continue as Chairman of the Board on a salary of $350,000 p.a. Bill explains to his lawyer that because his parents lived well into their 90s,
he intends to plan for a 20- to 30-year retirement. His lawyer asks Bill, ‘How is your business going to afford your salary?’

A key aspect of this scenario is the dependency of Bill’s retirement plans on Jerry’s ability to continue building a successful family business — essentially, Bill is putting 70% of the value of his estate and his retirement plans in the hands of Jerry. This arrangement also places a burden on the business to fund Bill’s salary in addition to any other challenges and expenses it may face — a commitment that may see it fail in the future. After discussing these concerns with his lawyer, Bill decides to negotiate a partial sell-down of his family business, which allows him to fund his retirement plans at $350,000 x 30 years = $10.5 million.

‘The critical issue [in this case] was the wealth extraction strategy from the business, striking an equitable balance between the interest of Bill, the interest of Jerry and the interest of other family members’, Perkins said.

**Estate equalisation**

Estate equalisation strategies are relevant to estate planning, especially if there are a number of business partners or children involved, and only some of them wish to remain active in the family business. ‘For example, if there’s a son and two daughters … how do you actually make sure that the son doesn’t wind up with the lion’s share of the value of the estate just because you want him to have the business when you don’t have enough other assets to equal the value of the business,’ Stinson added.

Often, the best solution if there is inequity in a family business is to have a diversified estate that includes other assets, insurance and investment strategies outside the business to allow the equitable distribution of the estate. ‘… insurance has a pretty big role to play, but one of the roles [of financial advisers and lawyers] … is to try and work out what the assets are and extrapolate what they might be on death and see whether, in fact, the rest of the estate is going to be more than enough to compensate the other family members for what was left to the son’, Stinson said. If there is not enough value that can be distributed from the estate, then cash will need to be sourced from elsewhere and that’s where insurance policies can play an important role.

**Options for ownership structures**

**Sole trader and partnerships**

A large percentage of family businesses are structured as sole traders or partnerships, which raises significant estate planning issues. These unincorporated structures not only create risk of unlimited liability, whereby the owners are personally liable for the debts of the business and the actions of any other owners, but also difficulties in transferring ownership of the business as a going concern.

These structures also offer limited benefits in terms of income and tax planning, with the owners taxed on their share of the business income at their marginal tax rates.

**Trust structures**

Most trust structures used by family businesses are family discretionary trusts. These are set up during a person’s lifetime and differ from testamentary trusts, which are created in Wills and become active once the testator dies. This article focuses on family discretionary trusts.

Family discretionary trusts allow a person (the trustee) to hold assets on behalf of another person or a group of people (the beneficiaries).

Trusts not only provide taxation benefits, but they may provide asset protection. This is because assets held in a trust are not personally owned, such as jointly owned assets like factories, so they are generally not available to creditors if a business fails or bankruptcy
occurs. Note, however, that if the trust is controlled by the ultimate bankrupt, it may be challenged by a trustee in bankruptcy.

The assets held in a family discretionary trust are considered non-estate assets and therefore, cannot be disposed of in a Will. This means that direction on how those assets should be handled, needs to occur through a legal contract or a non-binding document referred to as memorandum of wishes and reasons. When it comes to creating a family trust, the following roles and responsibilities may, as appropriate to the situation of the client, need to be filled:

- trustee
- appointor, protector or guardian
- beneficiaries.

These roles will be discussed in greater detail later in this article.

By passing assets into a family discretionary trust inter vivos — which is when the business owner is alive — an individual can have control over who is the appointor, who is the trustee, how the assets are distributed (that is, the terms of the trust), and who the beneficiaries are.

Trusts are also able to obtain the 50% capital gains tax (CGT) discount for assets that have been held for at least 12 months, and this discount can flow through to individual beneficiaries. ‘… [There] is something in the order of about 440,000 trusts on the ATO’s register these days, so it’s important to note that family trusts are a regular structuring technique’, Perkins said.

Tax efficiency is one of the main reasons why businesses are often owned by a family trust. Tax losses can also be brought forward in the trust to offset income in future years, although losses cannot be distributed to beneficiaries. In such cases, a tax adviser should be consulted.

Companies
Holding assets in companies is another approach that can also assist with asset protection and income planning. However, because assets that are owned within a company are not governed by a Will, they cannot be passed to beneficiaries.

For example...
A business factory cannot be passed to children via a Will if it is owned by the company. However, shares in a company can be passed on in a Will, subject to ownership arrangements.

For example...
If the shares are jointly owned, they will bypass the estate and go directly to the surviving owner, or if they are left to a child of the deceased in a Will, they will go to the child.

When it comes to companies, financial advisers really need to look at what company shares are on issue and what will happen to them on the death of the testator. It is also important to consider whether the executor will have the power to exercise any rights attached to the shares during the estate administration period. The constitution of a family company will dictate how many directors there can be, their voting rights and, ultimately, the director who controls the assets. On the other hand, the shareholders have some rights with regard to how those assets are managed and who the directors are going to be.

Family businesses succession
The 2009 survey of Australian family businesses conducted by KPMG and Family Business Australia, found only 15% of family business owners said they had a formal succession plan in place, while 31% said they were currently in the process of developing one.

The survey also found that over 40% of respondents intended to pass on the business to either the next generation or to other family members. (KPMG, 2009) When it comes to business succession there are really two choices to transfer the business:
- after death
- inter vivos (while a person is still alive).

The advantage of transferring business ownership inter vivos rather than after death is that it enables an effective transition of ownership, and the business owner may able to take advantage of tax concessions, such as the small business CGT concessions that would otherwise be unavailable.

Perkins believes that when it comes to business succession, the key successor decisions relate to:
- ownership succession
- management succession.

Consider…
Selecting the right successor to own the business is just as important as choosing the right manager to deal with the operation of the business on a day-to-day basis. In a worse case scenario, getting this wrong can cause the business to fail.

‘You can get the ownership right and get the management wrong. You can get the management wrong and the business evaporates. You get the ownership wrong and well maybe, you’ll have a fight for the business to survive. It’s very important to deal with both’, Perkins said.

If a business is owned personally, then succession needs to be addressed in a Will. However, Stinson warns that leaving assets in a Will can leave a business exposed. ‘For example, more common these days, we have what people are calling family provision claims being made not only by widows, not only by children but by grandchildren and now even by carers, and [the deceased business owner] may well find that their best-laid plans in the Will are quite cleverly wrecked by somebody outside making a successful claim on the estate’, Stinson said.

To help protect against a Will being challenged, a family trust structure can be established inter vivos to ensure that the underlying equity in the business is actually owned by the trust and not personally by an individual business owner. This means that succession of ownership and asset transfers will be given by way of handing over shares in the family trust while the business owner is still alive.

Nevertheless, at least in some states, it is still possible for asset ownership in a family trust to be challenged (through a family provision claim). The success of that challenge will depend on the nature of the case, as well as the different family provision laws of the jurisdiction where the death occurred. It is best to seek further legal advice on these matters, as they are beyond the scope of this article.

Assigning roles and responsibilities
Very often, it is likely that someone will need to deal with the ongoing operations of a business after the death of a business owner, which makes it essential that key roles and responsibilities are assigned. It is important to make sure that the names of the people who
have crucial roles and responsibilities to play in an estate plan are kept up to date, especially when family dynamics change.

It can also be extremely helpful if names and contact details are given to the financial adviser or any other professional who might be required to perform estate duties. This can help to expedite the process when the time calls.

The most common roles that need to be filled in an estate plan and addressed in a Will include:

- a change of trustee (for example, in the case of a family trust)
- an executor
- a trustee of trusts set up in a Will
- an appointor (of trusts)
- the beneficiaries.

In the case of a family trust, where the terms will be governed by the trust deed, a Will cannot provide the trustee with any discretion to decide who should receive the capital and income of the trust. In the case of a trust set up in a Will, the reverse is the case. ‘The family business provides the profit and the cash stream from which a family can then get on with its life, and the business of responding to family needs becomes then the rightful role of the trustee of the family trust’, Perkins said.

It is also important to determine the appointor of the trust, whether set up as a family trust or in a Will. The appointor, protector or guardian is the person who has the right to remove and replace a trustee or otherwise supervise the administration of the trust.

The role of executor of a deceased estate is a position of trust and comes with great responsibility. So, appointing the right executor and trustee for any trust set up in a Will is an important decision. If the estate is complex with various ownership arrangements, then it would be prudent to appoint someone with proven business and accounting skills. Alternatively, if it is a simple estate, then perhaps a trusted friend may be appropriate.

A good executor will ideally be someone who is willing and able to undertake the role, is likely to survive the testator, has knowledge of the type of assets within the estate, is honest and impartial, and will seek expert advice when needed.

Unlike a Will, an enduring power of attorney (POA) operates while a person is alive, and in contrast to other forms of powers of attorney, continues to have effect, even where the person who has granted the POA becomes mentally incapacitated. An enduring POA can help a person deal with any business and commercial decisions that need taking care of. This is particularly useful if the grantor is no longer mentally or physically able to do so.

**Wrap up**

Providing estate planning advice to family business owners is a specialised area and one that requires specific knowledge and skills to ensure that recommendations are appropriate.

Financial advisers will often need to work closely with other professionals, such as lawyers, accountants, estate practitioners, family business advisers and tax advisers, to ensure that estate plans are appropriate, sufficient and effective.

Advisers also need to ensure that family business succession plans address the unique characteristics of the business, as well as the client’s individual situation and wishes.