



# Succession Planning and Personal Wealth Management

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Succession Planning is not only about the business or professional practice of the Principals but also the Principal's personal welfare financial and family security.

Hence careful consideration should be given to non business issues such as a Principals individual retirement needs and objectives. Careful assessment of the type of business or professional practice of a Principal will ultimately determine the correct exit strategy in the event of retirement, illness or death.

An important consideration for Principals of a business or professional practice is to plan well in advance to achieve a quality lifestyle during and after the business or professional practice succession planning process has been finalised and implemented.

A consideration of the quality of lifestyle after succession of the business or professional practice is the key that unlocks the whole succession process by allowing a Principal to see a life beyond a full-time role in the business or their professional practice.

What follows is an overview of the issues involving personal wealth management of a Principal of a business or professional practice.

## Planning into Action

In many circumstances Principals of business may rely on cash flow or sale proceeds from their business to meet retirement - related living expenses. The retiring Principal needs to ensure that the "source" of cash flow is adequate and protected. Hence succession, in the event of retirement, illness or death for Principals of business is especially challenging, as their retirement and estate plans are generally interrelated to other critical issues such as management, succession and development, tax planning, transferring equity, business valuation and financing of the business.

## Personal Needs and Objectives of Principals

The starting point for the deliberation of a succession plan includes consideration of the Principals:

- Vision - Future of the business:
  - Within the Family;
  - Outside the Family,
- Outright retirement from the business or part-time involvement within the business,
- Full handover of the business in respect to:
  - Management;
  - Control; and



- o Involvement to a Successor,
- Role within the business - Post retirement,
- Retirement lifestyle objectives,
- Time to Retirement,
- Capital available for Retirement from the business,
  - o Before Retirement,
  - o At Retirement,
- Sufficient wealth to fund the proposed lifestyle post retirement by keeping or selling the business,
- Other issues are likely to affect retirement cash-flow needs (such as health and life expectancy) other needs may also include supporting spouse, family obligations (such as care for disabled relatives) or tax-effective estate plans.

This might include assessing the level of capital available for retirement and determining whether or not that would be sufficient to enable the Principal to retire comfortably. Where the amount of capital available for retirement is inadequate, appropriate planning strategies can be adopted to deal with this situation.

Spending time with a Financial Adviser will no doubt lead to recognising other needs such as financing large purchases like a holiday home or boat, continuing study, and philanthropic activities that may require an investment of time rather than money or both.

Many Principals will also want to guarantee the financial security of their spouse and there may be concerns about coordination of retirement plans with the assumptions of the Principal's successor. Some

Principals may realise that they don't want to retire 'completely', preferring instead to work indefinitely in some other capacity. Others may choose to fund education for their grandchildren.

### **Formalising Objectives**

Whatever plans, formalising creative retirement objectives and applying a timetable for achieving them will prove an invaluable exercise. Working through this process will enable realistic plans to be clearly articulated to the Principal, Family Associates and Advisers.

Not having a clear picture of potential requirements increases future exit plans falling short of vital funds whether it be in retirement, illness or death. 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 to understand and to quantify those desires in detail to ensure that the desired financial objectives can be met in the event of retirement, illness or death of a Principal.

### **Investment Strategy**

In formulating an investment strategy consideration will need to be given to the following:

#### **Time**

All Principals 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 or professional practice operations, many Principals don't have the time or energy for personal investment management.



The demands of managing business or a professional practice can at times be so great that little time is spent reviewing and monitoring investment performance.

Very busy Principals may simply defer capital investment decisions to a financial adviser. That individual, while professional and committed to serve, may also be influenced by business pressures to advance certain investments or by personal interest in securing a 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 Principal.

### **Investment Diversity and the business**

Investment diversity also presents a special challenge for Principals. Growing a business requires capital. During periods of growth, many Principals answer part of the need for capital by constantly reinvesting profits back into the business or professional practice. As a result, a large diversified personal investment portfolio may not be accumulated. The business thus becomes the main or only investment 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 Principal, 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 seeking professional investment advice.

### **Investment planning using an adviser**

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

- Overall life style and personal objectives,
- Match personal objectives,
- Personal risk tolerance including the appetite of the individual to take on risk at certain points in time within their life,
- Level of knowledge relating to investing – including an understanding of the business as a separate asset class,
- Current investment strategy,
- Current investment portfolio, and
- Current legal entities and the purpose behind such structures.

To offer the best counsel on succession issues, investment advisers must also have a clear understanding of:

- The Principal's business as a separate Asset class,
- 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 Principal may find that the new owners will require transitional assistance with bank arrangements or other business relationships that may involve some form of financial pledge from the Principal,



- Human nature, especially when dealing with a family business. Estate planning and birthright or fairness issues between beneficiaries working in the business and beneficiaries working outside the business can complicate the investment planning process,
- 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,
- The Principal's:
  - Retirement plan,
  - Will,
  - Insurance needs, and
  - Personal income tax and capital gains tax.

This information may have a direct impact on investment decisions, as misunderstood tax issues or unanticipated cash needs will certainly derail investment strategies.

A failure to understand a Principal business or practice commercial issues and how the business and/or professional practice is aligned to their personal wealth objectives inevitably results in the Principal having little faith in dealing with investment advisers.

### **Tax**

Principals of privately held enterprises, often accumulate net worth in their business through goodwill that can be subject to tax on sale. For this reason, all Principal's

should review their tax exposure.

Principals of privately held enterprises often have no real sense of the value of their enterprise. The Australian Taxation Office, on the other hand, will exhibit no such ambiguity and will assuredly assign a value.

As the wealth of Principals of privately held enterprises is typically tied up in illiquid assets, the imposition of the tax may force potential beneficiaries to sell the enterprise in order to pay it. For example, on the sale of an enterprise or shares in an enterprise, consideration may be given to purchasing shares in the acquiring corporate entity. However, if capital gains rollover relief is not available, a tax impost would be incurred by the seller.

A tax liability would arise but, given that the consideration received is wholly or partly in shares rather than cash, a cash shortfall may arise when the time comes to pay the tax.

Therefore, as part of any consideration, a financial adviser should be appointed in order to determine the value of current estate and for assistance in projecting its future value. Prior to that, a determination of the extent of any tax exposure in order to prepare the way for further succession planning is needed.

### **Other Considerations**

A tax plan cannot be developed in isolation. The various other plans and commercial matters impacting on the organisation must also be considered. Other plans include developing and motivating management talent, transferring ownership, retaining key employees, retirement planning, cash flow



and investment portfolio strategies.

As there are many strategies to minimise tax, it is often suggested this is an option for tax and only those who fail to plan actually pay. This is because (with appropriate planning) the imposition of tax can be minimised legitimately. In some cases, tax may be deferred where capital gains rollover relief is available. 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 enterprises - but creative strategies do exist to help reduce tax.

### **Entity Structures**

In advising clients in respect to succession planning it is important to have an understanding of various legal entities and the purpose of the various legal entities serve the Principal's business and the Principal's wealth management needs outside of the business. In particular in respect to personal investment planning outside of the business, it is important to understand how assets are held and protected outside of the business. Consideration should therefore be given to understanding trusts as a legal entity to isolate and protect assets for personal needs.

### **Trusts**

Trusts are used for a variety, of purposes. The flexibility of trusts is perhaps the major reason that they are so widely

used. 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 that are created only when someone dies). The terms of a trust may allow it to be changed (or even revoked), or it may be fixed or irrevocable at the date of creation.

### **Establishing a trust**

In establishing a trust, consideration needs to be given to whether or not the trustee will be an individual or a corporate entity and whether the trust will be a unit trust (with a unitholder) or a discretionary trust.

Once determined, the trustee needs to be established. In the case of a corporate entity trustee, a corporate entity would be established with shareholders and directors. Then, the trust is constructed (with the assistance of a solicitor) wherein the corporate trustee is identified, including the settlor and appointor.

The settlor is the person who settles or creates the trust and the appointor ultimately has the responsibility or ability to replace the trustee of the trust. Once established, the trustee is authorised by the relevant state revenue office and the trust comes into existence.

### **Appointing a Trustee**

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 the \$2 share capital of the corporate trustee) are put at risk.

### **Trust Deeds**

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 corporate entities as the appointor/s who have the power to replace the trustee. As the appointer 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 takes over if the appointor named in the trust deed dies, becomes incapacitated or retires.

## **Superannuation and the Principal of a Business**

### **Overview**

Superannuation planning is an integral component of personal wealth management.

Reforms of the superannuation regime, principally those effective from 1 July 2007, have significantly increased the focus on superannuation as a retirement and business succession tool.

The particular advantages of superannuation as a tool in personal wealth management arise from:

- The taxation concessions afforded to superannuation contributions, investment income and benefit payments; for example, deductible contributions and investment income are taxed at 15 per cent and benefit payments are generally tax-free for those aged 60 or more
- The superannuation fund owning assets that are used in the business; and
- Asset protection.

There are many ways that superannuation strategies can be developed. There are also many rules that need to be adhered to in order to ensure that the superannuation concessions are not lost. Nevertheless many Principals of a business are not familiar with the benefits of superannuation because they view their business as their retirement plan. Hence the importance of utilising advisers who understand superannuation in the context of Principals who have a business or a Professional Firm.



### **Tax concessions**

Tax concessions are valuable and should be considered in personal wealth management for many reasons, including:

- A reduced tax rate obviously gives rise to a higher net earning rate on investments,
- Lower taxes lead to lower tax payments, which in turn means there is less cash flow away from income-producing assets, and
- Tax savings can be generated by sacrificing earned income normally taxed at marginal tax rates of up to 46.5 per cent into superannuation contributions which are taxed at 15 per cent.

### **Wealth Extraction from the business and Contributions to Superannuation**

Principals are always seeking ways to effectively draw capital from the business. Hence consideration should be given to superannuation contributions.

Contributions to a superannuation fund may be claimable as a tax deduction for the contributor. An employer will generally be entitled to a taxation deduction for a contribution for an employee.

An individual may also be entitled to a tax deduction for a contribution where he or she is not entitled to and receives no superannuation support, or where his or her income and fringe benefits from employment is less than 10 per cent of income and benefits from all sources.

While the deduction may be unlimited, the recipient superannuation fund has a tax liability calculated as 15 per cent of those contributions.

In addition, while the full deduction for any contribution might sound appealing, where those deductible contributions exceed the individual's concessional contribution cap the individual will be assessed to a further 31.5 per cent tax on the excessive contribution. This means that the effective tax rate on those contributions is 46.5 per cent.

Contributions can also be made without claiming a tax deduction. These contributions are referred to as non-concessional contributions and are also subject to a contribution cap.

Other forms of contribution may also be available. For Principals, the most relevant of these are the additional CGT caps for certain amounts arising from the disposal of business assets.

These concessions recognise that many small business owners invest in their business rather than make regular contributions into superannuation and later use the equity in their business to fund their retirement.

The concessions apply to:

- Capital gains of \$500 000 that are disregarded under the small business retirement exemption
- Capital proceeds from the disposal of certain assets that are exempt (or would be exempt) under the small business 15-year exemption.

### **Work tests**

The timing of all forms of contributions to a superannuation fund can be critical, particularly around the time of disposal of a business.

For example, one of the conditions that must be



satisfied when a person contributes or has contributions made for them if they are aged 65 or more is that the person satisfies the 'work test'.

This requires certain hours of paid or gainful work within a certain period to be completed before contributions (including the CGT relief contributions) are able to be made into a superannuation fund. Sometimes the work test fails, particularly when the business has changed hands or management and the person does not have an active role anymore.

### **Benefits**

Perhaps the most significant reform to the superannuation regime was the abolition of the taxation on the majority of pension and lump sum benefits received after turning 60. In addition, pension and lump sum benefits received by those under age 60 also qualify for concessional tax rates.

Particularly relevant is the fact that there is no longer a Reasonable Benefit Limit on the amount of superannuation benefit that a person can receive and still be entitled to concessional tax treatment.

However, the taxation of death benefits has not been afforded the same levels of concession and particular attention needs to be paid to dealing with benefit in a superannuation fund in order to minimise the taxation and liquidation issues that will arise on death of a superannuation member, including capital gains tax and taxation of benefits in the hands of other family members.

### **Investments**

Superannuation fund investments generally qualify for concessional tax treatment with only limited instances where

income can be taxed at any rate higher than 15 per cent (for example, non-arm's length transactions and excessive trust and company distributions). A superannuation fund can be exempt on its income from assets that are used to support a pension being paid to a member of the fund.

For this reason, significant advantages can arise from having a superannuation fund owning assets that are available for use in the business. The most common asset is real estate, with the business paying rent for the use of the property and the income and gains in the value of the property accruing to the superannuation fund.

Because of these advantages there are several restrictions on the ability of a fund to transact with a business connected with a fund member (including loans, asset acquisitions and arm's length terms, restrictions on the types of assets that can be made available for use in the business).

Care needs to be taken by the trustees of the superannuation fund to ensure that any transactions with a member or related business do not cause the fund to breach regulatory requirements and become non-complying. A non-complying fund loses all of its concessional tax status.

### **Asset protection**

Previously there were limits on the amount of superannuation benefit that could be protected from creditors of a member. Following a series of bankruptcy law and superannuation reforms, contributions to superannuation should be protected from creditors unless the main



purpose is to prevent the contributions from becoming divisible among creditors, or to hinder or delay the process of making property available for division among the creditors.

With the abolition of the Reasonable Benefit Limit, a person's protection from creditors is also no longer limited to set amounts.

Despite the so-called simplification of superannuation, the rules regarding contributions (particularly CGT small

business relief rules), fund investments and the forms of benefit payments still remain complex and thus Principals should consider speaking with an appropriately qualified adviser.

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Melinda Wood - ili Enquiries (02) 9251 3611 [enquiries@ili.com.au](mailto:enquiries@ili.com.au)**