



Relinquishing Control in the Event of Retirement, Illness or Death

Issue 22 - 19 June 2009

Overview

Succession planning involves a bewildering array of increasingly sophisticated strategies and services. Nevertheless in the event of retirement, illness or death the choice and strategy essentially comes down to whether the principal either keeps, sells or liquidates the enterprise.

For principals of an enterprise, the choices are especially complex, and few are willing or able to devote enough time to planning their financial future correctly to meet their own particular circumstances. Also, principals who own successful enterprises often tend to believe that the enterprise or professional practice itself represents their personal nest-egg; that it will, in some unspecified way, guarantee them financial security when the time comes for them to step down in retirement or in the event of death or illness could provide for their family's security. This may well accidentally turn out to be true, but it involves a number of assumptions that cannot always be taken for granted.

What follows is an overview of how principals of an enterprise can plan to exit in the event of retirement, illness or death.

Wealth in or out of the Enterprise?

Financial peace of mind is a crucial ingredient in a successful retirement or in the event of illness or the death of the principal but there are two schools of thought on the best way for principals to engineer their own security. Broadly, a principal can either operate a policy of continuously extracting wealth out of the enterprise during their period of tenure, or a principal can leave wealth in the balance sheet of the enterprise so that it builds up to the point when, on retirement or death or illness, a restructure is arranged in order to transfer personal wealth to the departing principal of the Estate.

A program of cash withdrawal from the enterprise (to finance retirement and lifestyle arrangement) may, in the long term, represent a significant drain on the enterprise resources. On occasions it can seriously weaken the enterprise finances. Building up the balance sheet instead, however, exposes the principal to the risk that if the enterprise suffers financial troubles at some stage in the future, the effects will spill over into their personal financial affairs.

There are no obvious right or wrong solutions here. Much will depend on the individual circumstances, in particular the cash flow type of



enterprise and general resilience of the enterprise concerned.

If the enterprise can accommodate a long-term cash withdrawal program, then from the principal's point of view it offers important advantages:

- It protects the principal's personal wealth against enterprise failure;
- It enables the principal to spread his assets away from the enterprise, freeing money for investment in a balanced and diversified portfolio; and
- The principal can maximise investment returns by switching between asset classes and markets when opportunities arise.

There are a variety of strategies that represent a middle course between the extremes of continuous cash withdrawal and building the balance sheet that can be employed to provide financial security for the principal before they relinquish control. Possibilities include, for example, the business redeeming capital, partial liquidations, and the sale of interests to children working in the business at market or less than market value.

Furthermore consideration could be given to putting money annually into superannuation and separating business assets such as business real property from the enterprise and into a superannuation fund.

Understanding how best to gain wealth from the enterprise will eventually determine whether the enterprise will be kept, sold or liquidated.

Keeping the Enterprise

Choice of successor and the ability of the enterprise to provide the principal with tax effective income will determine whether the enterprise should

be kept in the event of retirement, illness or death.

The financial situation of a principal who continues to own the enterprise after retirement is likely to alter abruptly. As well as an end to benefits, the amount of money a principal can draw from the enterprise will be limited by the capacity of the enterprise to pay an income to both the principal and the successor as manager of the enterprise, and by rules that limit tax deductibility.

Also, if most of the principal's assets are tied up in the enterprise (as is often the case), retirement will become dependent on the ability of the next generation to manage the enterprise successfully. This may not be a problem, but some principals are actually forced out of retirement to take over from incompetent successors in order to protect their own financial security choice.

Selling the Enterprise

If the principal has no successors willing (or able) to take over the enterprise, or perhaps has insufficient funds independent of the enterprise to provide for retirement, or family security in the event of illness or death of the principal or if the principal simply has decided the time has come to start a new venture, then selling the enterprise may be the best solution. Possible reasons for selling include:

- The principal is not interested in the succession process;
- The principal is interested, but there is no successor;
- Poor prognosis for family relationships;
- The leadership loses interest
- A need to finance retirement;
- Economics – industry consolidation, for example;



- A short-term enterprise – it has achieved all it can;
- Carrying on is too risky;
- An excellent offer has been received;
- The principal's need 'to prove I can do what I want to do'.

Should selling the enterprise be considered as an option, consideration should be given to selling the enterprise to:

- Family members;
- Employees either as a management buy-out or a management buy-in strategy;
- Strategic sale to an institution;
- Trade sale to a competitor;
- Public listing; or a
- Combination of the above.

While there may be cogent justification for selling, there may also be strong reasons for not doing so. For example:

- It is the best long-term investment available for both the current principals and the next generation;
- The enterprise is part of the family; it is an important legacy;
- It is an opportunity for the children;
- The principal does not want the children to inherit a lot of cash;
- The enterprise is a flagship;
- It is important for the employees;
- It is something meaningful to do.

A principal needs to carefully weigh up the importance of the arguments and options to reach what is likely to be a very tough decision. A detached and logical approach, listing the advantages and disadvantages, will be helpful, but the process is also likely to raise some emotional dilemmas with which a principal must be prepared to grapple.

Liquidating the Enterprise

Sometimes the way ahead is clear and uncomplicated. If the principal has enough money invested outside the enterprise to provide for a secure retirement, and has planned for management succession, they may want to pass on their interest in the business to the next generation. On the other hand, there may be no suitable successor, or it may be felt that family relationships are likely to improve if the enterprise is sold. Perhaps the principal has simply had enough of the enterprise and would like to take on a new challenge. The answer in such circumstances may be to sell the enterprise. What maybe realised too late is that the enterprise is not capable of either producing sufficient income post retirement or never was possible. As such in both instances the enterprise may only be liquidated.

To find out more about ili courses and workshops in respect to Succession Planning please visit our website

www.ili.com.au.

Copyright Notice

©ili.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, transmitted or copied in any form or by any means (graphic, electronic, mechanical, photocopying, microcopying, scanning or otherwise) except as permitted under the Copyright Act, without the prior written permission of ili. Any enquiries should be addressed to ili.

Disclaimer

This publication is designed to provide accurate information regarding the subject matter which it covers. It is distributed on the understanding that ili is not engaged in rendering professional or expert services or advice (legal, accounting, financial planning or otherwise). The information provided in this publication does not constitute such advice or services and should not be relied on as such. If professional or expert assistance is required, the services or advice of a competent person should be sought. Neither ili nor its directors, employees, associates, agents or other representatives and affiliates are liable for any liability, loss, damage or injury arising from or in relation to the direct or indirect use of, or reliance on, the whole or any part of the information contained in this publication. Without limiting the generality of the above, neither ili nor its authors, consultants and writers are liable or responsible for anything done or omitted to be done by any person in respect to this publication.

For Further information please visit www.ili.com.au or contact:
Melinda Wood – ili Enquiries (02) 9251 3611 enquiries@ili.com.au