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Scottish   
Provident

## Business protection toolkit

Protecting your clients' business



# The complete business kit for advising your clients

**Any business, large or small, is likely to face the unexpected at some time. But your clients can reduce their risk by planning ahead so their business is protected for the future.**

This toolkit highlights the areas businesses need to protect – key employees, partners and shareholders. Whether your client is in a partnership, a sole trader or a company, this toolkit takes you through what you need to know when advising your clients about the importance of having adequate business protection in place.

To give you further support, the CD at the back of the pack has a range of tools to use with your clients:

- **Sales aids**
- **Sample letters and trust wordings**
- **Premium Equalisation Calculator**
- **Presentation for your clients**

Help protect your clients against the unexpected with Business Protection from Scottish Provident.

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# Partnerships and sole traders

**Intermediaries who are advising partnerships and sole traders on key person and partnership protection will find this section of the toolkit particularly relevant.**

The following pages highlight the key assets businesses need to protect – their key people. We focus on the technical aspects of business protection, and highlight how you can work with your clients to establish the most appropriate level of cover. The toolkit also explains how to deal with the various tax implications of protecting a business. We believe clients wishing to take advantage of the wide ranging benefits offered by our protection plans will find the information useful.

Please note: The information contained in this guide is based on our present understanding of current law and HM Revenue & Customs practice. It is not intended as a substitute for legal, taxation or other professional advice. If you have any doubts as to the legal or tax implications of the information, we recommend you seek the advice of a suitably qualified adviser.



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## Introduction to business protection for partnerships

People are critical in small businesses. If an owner, partner or key employee dies or falls ill, the impact on the business can be enormous. The immediate concern will be to ensure that the business can continue to operate until a replacement can be found, or until the colleague returns to work. Cash flow can become a major headache. While sales may fall, expenditure continues and the business's main priority will be to make sure that there is enough cash to meet its existing outgoings such as wages, creditors and other overheads. In short, the business has to continue.

Thankfully, Business Protection helps business owners protect against such unfortunate circumstances. It enables owners to plan for the unexpected by providing cover to ensure the business can continue with minimal disruption. Business continuation cover encompasses key person and loan protection.

For partnerships, there is another aspect to business protection which is just as important yet is so often overlooked. In the event of the death of a partner, the remaining partners face the question of how to guarantee that they will be able to regain control of the business. In most circumstances, partners will leave their assets, including their interest in the business, to family members. For the remaining partners, the primary concern will be to regain full control of the business as quickly as possible.

Business Protection allows your client to regain control of their business if a partner was to die. It addresses issues such as:

**What is the true value of the business?**

**Should the value include any goodwill?**

**Where will the remaining partners secure funds to buy the interest?**

**What if the deceased's interest can't be purchased if there are no funds available (i.e. will the family or third party be entitled to a share of profits?)**

On the other hand, the family of the deceased will have different concerns. They will want to know:

**How can they ensure that they receive a fair value for the interest in the business?**

**How long will it take for the other partners in the business to buy out their share?**

These issues don't just arise in the event of death. If a partner suffers a critical illness, he may well decide to retire from the business and will look to receive a fair value for his interest.

A partnership protection scheme can easily resolve such problems by providing:

1. An agreement setting out how shares in the business should be valued and allowing the remaining partners the right to buy the interest in the business and
2. The funds to allow the interest to be purchased.

Partnership protection and key person protection are often confused. It's important to establish at this stage why the cover is required to ensure the plan proceeds fall into the right hands.

The following pages highlight each area in more depth.

## Key person protection

### Is there a need for key person protection?

When business owners are asked what business or partnership assets are insured they always list their premises, plant and machinery, vehicles, computer equipment and so on. They recognise that cover is required for the cost of replacement, potential loss of profits and ultimately to minimise any business disruption.

However, what could happen to the business if a key employee, partner or proprietor were to die or become critically ill? The cost to the business could be devastating. Consider for example the sudden death of the head engineer when the business is in the process of tendering for a major project. Their death could result in the loss of that contract which may be critical to the future survival of the business.

### Who is a key person?

A key person is someone whose death, critical illness or disability would have a serious effect on the future profits of the business. In any given business a number of people could be regarded as "key" including the partners, senior employees or the proprietor, in the case of a sole trader. Although the number of key individuals may vary from one business to another, there will always be at least one key person in any given business. The obvious choice of key person will normally be some or all of the partners in the business. However, clients should also consider the impact on the business of losing someone who although they may not have any financial stake in the business, nevertheless play a fundamental role in its success.

You need to determine key people by asking:

- **How easily could the business replace their expertise?**
- **Would their absence affect business expansion plans or ongoing projects?**
- **Would the business be in danger of losing customer orders?**
- **Would it result in a loss of goodwill or hardening of suppliers' credit terms?**

- **Would the business miss their administration or management contribution?**
- **Are there any loans or overdrafts dependent upon the key person?**

### Calculating the risk

Once you've identified those individuals key to the business, the next step is to establish the level of cover required. There are no hard and fast rules when assessing the financial value of a key person. Each key person must be dealt with on their own merits. There are several options available to guide you in assessing a reasonable amount of cover, and these are outlined below:

#### Multiple of profits

This is the primary method of calculating the key person's worth. The normal multiples are:

2 x gross profit OR 5 x net profit

The profit may need to be split where there is more than one key person.

Higher multiples may be justified for a rapidly expanding business.

#### Multiple of salary

Where the key person is an employee rather than a partner, a multiple of gross salary, including benefits in kind, can give a useful guide to the amount needed to buy in a replacement. Up to 10 x gross salary may be considered.

#### Proportion of salary roll

An alternative for employees is to calculate the key person's contribution to turnover. The formula used would be:

$$\frac{\text{Key person's salary}}{\text{Total salaries}} \times \text{Turnover} \times \text{years to recruit and train a replacement}$$

It will usually take at least a year to train and recruit a replacement but in some cases it could be argued that three or even four years is more appropriate.

## Special circumstances

### Business start up

The working capital at risk must be calculated, together with the key person's proportion of this risk.

### Summary

There is no one solution. We'll consider carefully any reasonable figure proposed.

## Which type of cover?

Given that key person protection is intended to cover future loss of profits, the cost of finding a replacement, training them and the business lost may only become apparent after a number of years. This suggests that term assurance to the key person's normal retirement date may be appropriate. The business can choose to have the sum assured payable as a lump sum or possibly by installments. However, depending on who the key person is, their involvement with the business may not last until retirement therefore perhaps shorter term cover is preferable, say for five or ten years.

Another option is whole of life. Although this does not tend to be the obvious choice for key person protection, it can be advantageous where the life assured is a founding or managing partner who has no intention of retiring. Even if the key person leaves, it may be beneficial to assign the plan to them. The taxation implications of doing so are discussed later in the handbook.

The ultimate decision as to which type of plan to choose can often depend on the comparative costs of the premiums and the taxation implications.

## Writing the plan

Whatever type of plan is used for key person protection, it is important to remember that the plan should be set up for the business to ultimately receive the proceeds.

Where the business concerned is a limited company, setting the cover up is fairly straightforward. As the company is a separate legal entity in its own right, it can take the plan out on the life of the key person, i.e. it can effect a life of another plan.

However, in the case of a partnership, this is a potential problem. In England, Wales and Northern Ireland, a partnership is not a separate legal entity in its own right and therefore cannot take out a key person plan. There is however a solution to this problem – the key person could insure their own life and place the plan under trust for the benefit of all the partners in the business (a Business Trust is offered for this purpose. A copy of this is included on the Toolkit CD).

In Scotland, this is not an issue, as a Scottish partnership is a separate legal entity. Therefore the plan can be set up as life of another with the business as both owner and the recipient of any benefits.

## What about a limited liability partnership?

A limited liability partnership (LLP) is halfway between a limited company and a partnership. It is a legal entity in its own right and it is completely separate from its members. It is registered with the Registrar of Companies and it must follow regimes for accounting, disclosure of financial information and insolvency almost identical to limited companies. The liability of the partners is limited to the amount subscribed for the LLP. However, for taxation purposes, the individual partners are treated as if they are self employed individuals, just as if the LLP was a partnership. If an LLP wishes to take out a key person plan, this would normally be written on a life of another basis with the LLP owning the plan.

## The tax implications

One of the main reasons why there are not more key person plans written is because of uncertainty over the tax treatment of premiums and benefits. The reason for this uncertainty is down to the fact that there is no legislation on the subject of the tax treatment of key person plans. The only guidelines we have on this were set out in a statement made in 1944 by the then Chancellor of the Exchequer, Sir John Anderson, in which he said the following:

*“Treatment for taxation purposes would depend upon the facts of the particular case and it rests with the assessing authorities and the Commissioners on appeal if necessary to determine the liability by reference to these facts. I am, however, advised that the general practice in dealing with insurances by employers on the lives of employees is to treat the premiums as admissible deductions, and any sums received under a plan as trading receipts if (i) the sole relationship is that of employer and employee; (ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee; and (iii) it is an annual or short term insurance.”*

### What does this mean in practice?

In order for a business to qualify for tax relief on payment of key person plan premiums, **all three** of the following tests must be met.

#### 1. Sole relationship

The relationship must be that of employer/employee. If the life assured has a significant stake in the business relief would not normally be allowed. If the life assured is a partner in the business, clearly as an owner of the business, the plan will fail this test on the grounds that it is not wholly and exclusively for business purposes.

#### 2. Loss of profits

The plan must be intended solely to meet loss of profits arising from the death of the key person. Any plan with a surrender value will not qualify for relief on the grounds that it is not wholly and exclusively for business purposes due to the investment element. The level of cover must also be reasonable and this is usually addressed at the financial underwriting stage.

#### 3. Short term assurance

There is no clear definition as to what constitutes short term assurance but it is generally accepted this means five years. Five year renewable insurance is usually allowable.

#### Can these tests be relied on?

It is generally accepted that these rules are for guidance only. The application of these tests can depend on the facts of the case and therefore it is usually recommended that the tax treatment is confirmed in writing by the local Inspector of Taxes. A sample letter is included on the CD for this purpose. It is usually recommended that the business or their accountant writes to the Inspector when the plans are being set up to confirm the tax treatment. Although the Inspector will most likely issue a disclaimer in their response, the fact that clarification was sought should strengthen the client's case should the tax treatment be challenged at a later date.

#### What about any proceeds paid out under the plan?

The main reason it is so important to clarify the tax treatment of the premiums is that this can also have a bearing on the tax treatment of the proceeds. The general rule is that if the premiums have qualified for tax relief as a business expense, the proceeds will be taxable as a trading receipt.

In practical terms, partnerships are only generally likely to suffer tax on the proceeds paid where the partnership itself (in Scotland, or an LLP) owns the plan or where partners have applied on behalf of the partnership and the life assured is solely a key employee and not a partner. In all other cases, the proceeds will be paid into a trust for the partners individually and then paid into the business as capital introduced without the proceeds being taxed.

If tax relief has been given on the premiums, the proceeds from the plan will be subject to income tax in the partnership accounts. This means that this will increase the profit share of each partner and be taxed on them accordingly at their highest rates of tax. Rather than having a full tax charge on plan proceeds in year one, proceeds can be spread over several years with a view to matching the actual related expenses in later years. If the client is choosing this option it is important to ensure that this is chosen at the outset when the plan is set up otherwise the HM Revenue & Customs may treat the proceeds as taxable in full in the accounting period of claim.

### Proceeds paid in instalments

Both our business term and business whole of life plans contain an option at inception to have the proceeds paid in instalments. The details of this option are currently as follows:

Benefits may be paid in annual instalments over three or five years with a choice between level or increasing instalments. We will increase the sum assured according to the table below.

Number of yearly instalments	Increase in sum assured
3	5%
5	10%

(These increases are subject to change).

### Is the payment of the proceeds a chargeable event for tax purposes?

If the plan is a non qualifying plan, any gain made on the plan will be subject to income tax under the normal chargeable event rules, (S484(1) ITTOIA 2005). If a gain arises, the taxation of the gain will depend on how the plan has been set up. If the key person or one of the partners has taken out the plan and written this under trust, as settlor of the trust they will be taxed on any gains at their marginal rate. The partners could obviously reimburse them for their share of this tax. If the business takes out the plan, any gain will be split between the partners in the business.

However in practice it is extremely unlikely that a gain will arise as the surrender value prior to death (if there is one) would generally be less than the premiums paid.

### What if critical illness is included?

Critical illness is not a chargeable event for tax purposes. In all other respects, the tax treatment in relation to premiums and proceeds will be the same as for life plans.

### Should disability income benefit be included?

Premiums paid on a disability income benefit are unlikely to be tax deductible for the partnership. If the life assured is a partner, by applying the three tests in the Anderson Principles the plan would fail to get tax relief on the grounds that the relationship is not solely employer/employee. Any benefits would normally be paid tax free to the partners, either as beneficiaries if the plans are set up in trust, or as drawings if paid directly to the business. However if the life assured is a key employee, the plan is

owned by the business and the benefits are to be used for profit protection, the proceeds are likely to be taxed as a trading receipt in the hands of the partners as the plan is not intended to secure a lump sum. If the proceeds are then passed on to the key employee as "sick pay", the payments will be subject to PAYE and national insurance as normal. If it is intended to use the payment as sick pay for the employee it can therefore be more beneficial to have the key person take out the plan individually. The business could pay the premium on their behalf, which would be taxable as a benefit in kind. The proceeds would however be paid out tax free to the individual.

### Are there any personal tax implications for the key partner or employee?

Unless the plan is taken out to cover sick pay as above, the answer is no. The benefit in kind rules do not apply to partners. Any premiums paid by the business on behalf of the partners will simply reduce their outstanding capital accounts, i.e. they will be treated as drawings from the business. For key employees, if the business or partners own the plan there will be no benefit in kind. There will normally be a benefit in kind for the individual where they have taken the plan out in their own name for their own benefit (as in the case of disability income benefit).

## Assignment

### Can the plan be assigned back to the key person personally if it's no longer required by the business?

If the life assured is a partner, the plan can be assigned to him personally with no tax implications. However, the position for an employee is somewhat different as the assignment could result in a P11D benefit arising. Where the ownership of the plan is transferred from the business to the employee, this is seen as a benefit in kind. If the transfer happens while the employee is still in employment or in the same tax year that the employee has left the business, the value of the benefit is based on the cost to the employer of providing that benefit. In practice, this means that the total premiums paid to date so far on the plan will be the amount chargeable to tax in the hands of the employee. Clearly if the plan has been running for some time this means that there could be significant tax to pay, therefore the business could keep the plan going until the tax year after the employee has left. In this case the benefit will be based on the market value of the plan which in most cases will be significantly less than the premiums paid.

## Key person protection for sole traders

### Who needs to be insured?

#### 1. The sole trader

The sole trader is the business, therefore they need to protect the profits of the business in the event of their death, critical illness or if they need to take time off due to sickness. Given that there is no distinction between them and their business, establishing cover for this purpose will be written in a similar way as personal protection. If the cover is solely to cover death, they would simply place the plan in a gift trust for their family. If critical illness is included, the plan could be written under a split trust with the family as beneficiaries of the death benefit. In the event of their death, the sole trader's family could meet the financial obligations of the business. On critical illness, the plan can pay the benefits directly to the sole trader allowing them to safeguard the future of the business. Disability income benefit could be taken out to compensate for lost profits or find a temporary replacement.

PLEASE NOTE: We do not offer split trusts for use with whole of life plans. This trust is only available for Self Assurance Term Plans.

#### 2. An employee

The sole trader may also wish to insure the life of one or more of their key members of staff. The loss of that person could have a dramatic effect on the business of the sole trader. Such a plan would normally be established on a life of another basis, with the sole trader being the owner and the life assured being the key employee. The benefits would then be paid to the sole trader in the event of a claim, to allow them to reorganise or find a replacement.

### Taxation

Tax relief will not be due where the life assured is the sole trader, as there is clearly a personal benefit to them or their family. If the business pays the premiums on such a plan, it would normally be treated as drawings from the business. If the life assured is a key employee, the same tests as already outlined on page 8 will apply in determining whether the premiums are allowable and the proceeds taxable. If the cover is designed to be used for sick pay, it will usually be better for the employee to take the cover out themselves. This will be a benefit in kind for the employee if the business pays the premiums on their behalf, but the proceeds would be paid to them free of tax.

## Loan Protection

Where a plan is taken out to ensure repayment of a business loan in the event of the death or critical illness of a partner or sole trader, the taxation treatment of the premiums and the proceeds are more straightforward than with key person protection plans. Since the plan will have been taken out to protect the capital of the business, Section 58 (4) ITTOIA 2005 states that no tax relief will be given on premiums in these circumstances. In the event of a claim, no tax should be payable on the proceeds.

Where the cover is designed to repay a partnership loan, usually the partners concerned take out personal cover and place it under trust for the other business partners. In the event of a claim, they would then pay their share of the money into the business to pay off the debt. If the partnership is in Scotland or is a Limited Liability Partnership, the partnership itself can be the owner of the plan if the loan is in the name of the business.

In the case of a sole trader, loan protection would be set up in a similar way to key person assurance, i.e. taken out on their own life and placed into trust for their family to pay off the outstanding loan on death.

No tax relief would be due on paying the premiums through the business, since the plan is specifically for loan protection purposes (Revenue Tax Bulletin February 1992).

## Partnership Protection

### Why is there a need for partnership protection?

A partnership is defined in section 1 of the Partnership Act 1890 as “the relationship which exists between persons carrying on business in common with a view of profit, other than by way of membership of a body corporate.” There is no longer any limit as to the number of partners a business can have.

Within a partnership, each partner has an interest in the business rather than the ownership of ordinary shares, as would be the case in a limited company structure. In the absence of a partnership agreement, section 33 of the Partnership Act 1890 states that the partnership is dissolved if one of the partners die. The valuation of the deceased partner’s interest is based on their share of the assets of the business.

The valuation of this interest can be difficult and therefore it is strongly recommended that the partnership has a formal agreement which sets out how this value will be established and allows the business to continue in the names of the remaining partners.

#### Family interests

In the event of the death of a partner, the beneficiaries of the estate will usually be their family. They may have no experience of running a business and may not be able to contribute to it in any way. In these circumstances they will usually wish to withdraw their share of the capital at the earliest opportunity. Having partnership protection in place ensures that the family can receive a fair value for that interest.

#### Partners’ interests

From the surviving partners’ point of view, they will be continuing to run the business with a sleeping partner taking a share of the profits. They will therefore be keen to ensure that they will be in a position to regain control of the business by paying the family their share of the business back as soon as possible. Partnership protection ensures that the partners will have sufficient funds to do so.

To be effective, a partnership protection arrangement should consist of three main elements:

1. An agreement setting out how the interest will be valued and the rights of each party.

2. Insurance cover to ensure the funds are available to buy out the interest.

3. A tax efficient structure.

Before reviewing the different types of business agreements in detail, the starting point for any effective partnership protection arrangement should be to consider the individual partners’ own personal wills.

### Why is the personal will relevant to partnership protection?

The personal will of each of the partners is important for a number of reasons. Firstly, it is essential to establish who will inherit the interest in the business. Once this has been established, the next step is to consider the timing of any potential purchase of that interest by the other partners. It is in the interests of both the family and the other partners to have probate granted on the estate as soon as possible and the business interest purchased. An up-to-date valid will can help to achieve this.

However, the principal reason for reviewing the partners’ wills prior to setting up a partnership protection arrangement is to ensure that each of the wills is tax efficient. In particular it is important to ensure that full advantage is taken of any Business Property Relief (BPR) that may be available for Inheritance Tax (IHT) purposes. BPR is a highly valuable relief which is available on transfers of business property. It is subject to certain conditions being satisfied, both as to the type of business and the period the interest has been held. In order to qualify for BPR, the share in the business must have been owned for at least two years and it must be a trading business (not dealing in securities and land and buildings or making investments). The rates of relief available are as follows:

<b>A business or an interest in a business (including a partnership share)</b>	<b>100%</b>
<b>Shares in unquoted companies (includes AIM shares)</b>	<b>100%</b>
<b>Controlling shareholdings in quoted companies</b>	<b>50%</b>
<b>Land or buildings, plant or machinery used for a business carried on by a company of which the transferor had control or a partnership in which he is a partner</b>	<b>50%</b>

It should be noted however that no relief is generally given where a rent is charged for an asset owned personally but used for business purposes.

## The By Pass Trust

The By Pass Trust is a discretionary trust established in the will of the partner. On the partner's death, the value of the business interest would be left to the trustees of the By Pass Trust to hold in trust for the beneficiaries. No IHT charge will arise at that point if BPR is available. The partner can decide who the beneficiaries should be. In practice, if a partnership protection arrangement has been established in their lifetime, the other partners can buy out his interest in the business and the consideration can then be placed into the By Pass trust. The trustees can then invest the money and pay income, capital or even make loans to any of the beneficiaries including a surviving spouse or civil partner. Full details of the By Pass Trust can be found on the CD.

However, it's not just the individual's will that needs to be considered. The business needs to have a "will" to determine what happens on the death of the partners.

## The partnership agreement

A surprisingly large number of partnerships have no partnership agreement in place. This is a crucial document that not only sets out how the profits and capital of the business should be shared, it also states what should happen in the event of dissolution of the partnership, retirement, death or ill health of any of the partners.

Any existing partnership agreement must be reviewed before recommending or arranging partnership protection plans to ensure there is no conflict. There are three main types of agreements that are generally used for partnership protection purposes. These can either be incorporated into the main partnership agreement or they can be contained in a separate deed.

1. Automatic accrual
2. Buy and sell agreement
3. Cross option agreement

The differences between each type of agreement are discussed in the sections that follow, however, regardless of the type of agreement, they should all include the following main points:

**Names and addresses of the partners entering into the agreement**

**Business address**

**An undertaking to ensure sufficient cover is maintained**

**An agreement to review level of cover on a regular basis**

**Details of how and who will value the business**

**A fall back should there be a shortfall in plan proceeds to meet the cost of the share of the business, i.e. how will any balance be paid?**

It is important to be aware of the differences between the agreements in order to decide on the one most suitable for the client's needs.

### **Automatic accrual**

This type of agreement is only available to partnerships and does not involve an actual sale or purchase of the deceased's share of the business. Instead, an agreement is entered into whereby on the death of a partner, the partnership is allowed to continue and the deceased partner's share in the business automatically passes to the remaining partners. The deceased partner's estate does not receive any payment for his interest in the partnership. Instead the individual partners all have responsibility to take adequate life cover in their own names for the value of their share in the partnership, by way of compensation for their families. Each plan would normally be placed in trust for the benefit of family members in order that the proceeds would be outwith the deceased's estate for IHT purposes. If all partners participate then no IHT liability will arise on the premiums paid where they are shown to be a part of a bona fide commercial agreement. If the proceeds of a plan are less than the value of the deceased partner's share of the business, the agreement would normally require the surviving partners to make up the shortfall.

If BPR applies to the value of the deceased's interest, no IHT will be payable on the transfer to the remaining partners.

### **Buy and sell agreement**

The partners enter into an agreement whereby, on the death of any one of them, the remaining partners must buy the deceased's interest in the business and the deceased's estate must sell. The purchase of the deceased's interest in the business will normally be made by the survivors in proportion to their existing interest in the business but an alternative split can be put in place.

To finance such a purchase, each partner has an obligation to take out life cover on his own life and write it in trust for the benefit of fellow partners. Alternatively they must take out 'life of another' plans on the lives of his fellow partners. The merits of each of these options will be covered in detail later in the guide.

The major drawback of this buy and sell agreement and the reason it is seldom used is the potential charge to IHT due to the loss of BPR for qualifying business assets. The buy and sell agreement is treated as a binding contract for sale at the time of the partner's death. Therefore under the IHT Act 1984 s 113, the partner's interest in the business is not deemed to be business property and so does not qualify for the relief.

### **Cross option agreement**

This agreement is similar to the 'buy and sell agreement' but the surviving partners have the option to buy and the deceased's executors have the option to sell. The option period would normally extend to three months from the date of death. If one party wishes to exercise their option, the other party must comply. So for example if the surviving partners wish to buy the deceased's interest in the business, their executors have no option but to sell. This arrangement is often known as a 'double option agreement'.

Its major advantage over the 'buy and sell agreement' is that as it only gives the option to buy/sell and is not a binding agreement to sell on the death of a partner, business property relief will be available for qualifying business assets.

Life cover is set up in the same way as for the 'buy and sell agreement'.

A specimen wording for the cross option agreement is contained on the CD.

### **What if critical illness is included?**

Critical illness cover for partnership protection can be as important as life cover.

Critical illness can often result in a partner withdrawing from the business. Any of the agreements outlined above can accommodate a transfer or sale in the event of critical illness. However, in the case of the cross option agreement it would be usual to incorporate a single option on critical illness. The single option allows only the partner who is ill the right to exercise the option. This means that they cannot then be forced out if they feel that they will be able to return to the business once they have recovered.

If they fail to return to work after a period of time, it is also possible to then give the remaining partners the option to purchase after an agreed period.

In the event of terminal illness, a single option can also be appropriate as it means that the affected partner cannot be forced out of the business. Although they can opt to sell their share if they wish, they can choose to keep them until death, as their share in the business may attract BPR for IHT purposes and no capital gains tax would generally arise on the sale.

### **Which agreement is best?**

The answer is that it depends on the individual circumstances. Automatic accrual is simple and therefore a popular choice for partnerships, in particular small firms where the main asset is goodwill. Although the Buy and Sell agreement is also simple, the loss of BPR can be costly. It is generally believed however that the Cross Option Agreement is the most tax efficient.

We can provide sample cross option agreements but separate legal advice should always be sought.

### **Valuing the business**

All of the above agreements should specify how and when (and by whom) the business should be valued. Valuing the business is a difficult task and usually this will involve the client's accountant in finding the most appropriate method of valuation. Partnerships in particular can be difficult to value as much of the value will relate to Goodwill.

Commonly used valuation methods are as follows:

#### **Average partnership profits**

With this method, the objective is to arrive at a figure for the maintainable profits for the business. This figure will usually be arrived at by looking at the trend in past and current performance. This usually involves renewing the accounts for the last three or four years, together with projections of future profits. Any unusual items would normally be excluded from this calculation. This figure is then multiplied by a suitable factor to give the value of the business. Although it is generally fairly easy to arrive at a figure for maintainable profits, it can be more difficult to decide on a suitable multiple. It is not uncommon to use a factor of between three and six for this purpose.

#### **Goodwill**

An agreement can be reached among the partners after taking professional advice on a method to value the goodwill of the firm.

### **Net assets**

As with companies, the net assets are not always a helpful guide to the firm's value, but they should be taken into account.

Whichever valuation method is used, it is important to review it on a regular basis to make sure there is adequate cover.

### **Writing the plans**

#### **How should the cover be written?**

Once an appropriate agreement has been drafted and a valuation determined, the next step is to consider how best to write the cover.

In the case of automatic accrual, the plans will be written on an own life basis and placed into trust for family members.

However, where the proceeds are required to be paid to the other partners in the business to allow them to buy the interest, there are two options available – own life in trust or life of another.

### **Trusts**

#### **Should life cover be written on the life of another basis or on own life and placed in trust?**

Writing a plan as life of another is the simplest option as it does not involve the use of trusts and no equalisation of premiums is required. Premium equalisation is covered in more detail later in this guide. However, if there are a number of partners it can lead to an excessive number of different plans in existence. If, for example, there are four partners then each partner would require to take out a plan on the life of each of their fellow partners, resulting in twelve plans being written. There could also be problems in proving insurable interest.

While at first it may seem complicated to take out a plan in which the partner is the owner and the life assured, and then place it in trust for the benefit of their fellow partners, it does have some major advantages.

The first is that fewer plans are required. For example, if there are four partners then each partner would require to take out one plan only on their own life. Therefore only four plans and four trusts would be required.

This option also allows flexibility to include partners at the time of death, not just at the outset. Therefore new partners can benefit, subject of course to them effecting cover in trust on the same basis. Where a partner leaves the business, then typically the trustees can assign the plan back to the leaving partner and they can continue premium payments on a personal basis.

Another reason why the trust route may be the preferred option is if critical illness is included in the plan. If the life assured suffers a critical illness they may decide to stay on within the business. If the plan is set up on a life of another basis, the proceeds will be paid to the owners of the plan, i.e. the other partner(s). The partner who has suffered the critical illness will have no control over the proceeds. However if they have established the plan on an own life under trust basis, as settlor and trustee they would have a degree of control over the proceeds. For example, the money could be invested within the trust and could then be used to buy their interest at a later date when the need arises.

#### **Are there any disadvantages with the own life in trust option?**

There are two main drawbacks of the own life in trust option. The first is that in order to ensure the commerciality of the transaction, premiums payable by the partners require to be 'equalised' so that each partner pays a commercial amount relative to the benefit he may receive (IHT Act 1984 s10). If premiums are not equalised, then the difference in premiums paid caused by the partners differences in age and size of stake in the business could be deemed to be transfers of value for IHT purposes. This of course may not be an issue if the difference in premiums is minimal, as the differences would be covered by annual IHT exemptions. However, the position in the event of a claim can be somewhat more dramatic if premiums are not equalised. In this case, the arrangement would not be completely commercial or in other words would involve gifts. If gifting is introduced, then this raises the possibility of an IHT charge on the proceeds under the gift with reservation legislation. This is discussed later under the heading **'Which type of trust is normally used in such arrangements?'**

For a three-man partnership the following formula would be used to work out partner A's equalised share of premiums to be paid:

Sum assured on A x B's premium	+	Sum assured on A x C's premium
Total sum assured – sum assured on B		Total sum assured – sum assured on C

The same principle would be applied for partners B and C and then the three partners would arrange between themselves to settle the differences in premiums actually paid.

A spreadsheet is available on the CD to assist with premium equalisation if required.

The other disadvantage of using the own life in trust route is that advisers need to be aware of the potential impact of the Pre Owned Asset Tax charge (POAT) which was introduced in the 2003 Pre Budget Statement and came into effect on 6 April 2005.

This is a charge to income tax which applies where an individual can benefit from an asset which they previously owned. The new charge is designed to counter IHT planning arrangements which by pass the Gift With Reservation of Benefit provisions yet still allow the donor to benefit from the asset given away. The tax charge applies to the annual benefit enjoyed by the individual. The method of valuing the annual benefit varies depending on the type of asset however no tax charge will arise where the annual benefit is £5,000 or less. Where the annual benefit exceeds £5,000, the full amount is added to the individual's other income for the tax year and is subject to tax at their marginal rate.

As already mentioned, POAT is designed to combat certain IHT planning schemes. However, unfortunately the use of business trusts for partnership protection purposes fall foul of these provisions since they include the settlor as a potential beneficiary (by virtue of them being a partner in the business). The trust is not caught by the Gift With Reservation of Benefit provisions as it is part of a commercial arrangement but the POAT charge does apply as there is no similar exclusion under the new legislation.

Having said that, it is envisaged that in most cases, any annual benefit would be within the de minimis limit of £5,000. Since the trust asset is a life policy the annual benefit will currently be calculated as 6.25% of the "open market value" of the policy. While the life assured is in good health it is envisaged that the open market value would be negligible, therefore the charge should not apply.

Where it may become an issue for the settlor is if they suffer from a critical or terminal illness and the funds sit in the trust for any period of time (e.g. if they decide not to sell their business interest). In that case it's clear the value of the trust fund will be considerably higher and therefore 6.25% may exceed the de minimis limit.

Any potential tax charges can be avoided if the settlor is removed as a potential beneficiary from the trust and this can be done using our standard deed to remove the settlor which is included on the CD.

#### **What type of trust do we offer?**

We offer a business trust drawn upon a discretionary basis. A copy of our Business Trust is included on the CD. The beneficiaries in the trust must be the co-business owners and not include ordinary family members of the life assured as this would lead to the arrangement not being classified as a commercial transaction. The life assured can be a potential beneficiary and the trust will not be treated as a gift with reservation. The reason for this is that as there is no actual gift being made, i.e. as it is purely a commercial transaction and as there is no intention to make a gift there can be no gift with reservation.

Extreme care should be taken however if premiums are not being equalised to ensure the life assured is not a beneficiary as this could be treated as a gift with reservation and have a significant IHT implication with the proceeds being subject to IHT. If deceased partners wish their families to benefit from any surplus monies held in the trust after payment for their share in the business has been made they should ensure that the style of trust used does not allow them to be a beneficiary.

## **Tax implications**

#### **Is there any tax relief available on premiums?**

The answer is no. The premiums will be paid directly by each partner out of their taxed income. If the partnership pays the premiums on behalf of the partners they will be shown as drawings from the partners' capital accounts.

#### **Is there an income tax liability on plan proceeds?**

Where non-qualifying plans are used then any gain would be liable to higher rate income tax under normal chargeable event rules. However this will probably be of little consequence as the taxable gain is based on the surrender value immediately prior to death less premiums paid, as opposed to the sum actually paid out on death. In most circumstances the surrender value will be less than the premiums paid. Critical illness is not a chargeable event (Section 484 (1) ITTOIA 2005).

#### **What are the implications of using a discretionary business trust?**

The trust is subject to the 'relevant property' regime applying to discretionary trusts. In theory this regime can result in immediate IHT payable on lifetime transfers into trust plus 'periodic' charges at every 10th anniversary and 'exit' charges on capital distributed between 10 year anniversaries. In a business context however, the payment of premiums will not be treated as gifts or lifetime transfers where they are made as part of a property commercial arrangement. With regard to the 10th anniversary charges, then typically these will not apply for life cover given that following a death claim, the funds will normally be paid out of the trust immediately to the other partners in order that they can purchase the partnership share of the deceased. Accordingly funds are rarely sitting in trust at a 10th anniversary. In the unlikely event that they are, then the excess of the proceeds (or indeed the surrender value of the life policy should the individual be in very poor health at that time) over the available nil rate band will be subject to IHT at 6% on current rates. A more common scenario would be a case where critical illness cover was taken, and the partner chooses not to sell their business interest and the critical illness proceeds remain in trust beyond the 10th anniversary of the trust's creation. If so, periodic and exit charges might well arise unless the trustees decided to release the funds from the trust and for the other partners to then hold this money personally.

### **Is tax payable by the deceased partner's estate or family on the sale of the business?**

The sale consideration will usually be made up of two elements. The first part will relate to repayment of the partner's capital account and the remaining balance will normally relate to goodwill. No tax would be payable on the capital account element as this simply represents the partner's share of capital and profits which have already been taxed. Goodwill, however, is a chargeable asset for capital gains tax (CGT) purposes.

No CGT would normally arise on the death of the partner as the interest in the business is usually sold shortly thereafter by the estate and there is a tax free uplift in the value of the goodwill at the date of death.

However, if the sale takes place in the event of critical or terminal illness, there could be a CGT liability on a disposal of the interest in the business, subject to any business asset taper relief which may apply.

### **Is there any problem in using existing plans?**

Partners may consider assigning an existing plan into a business trust, but this can have serious tax consequences. HM Revenue & Customs can take the view that at the time of death the original owner did not hold the plan and that the current owners (i.e. the trustees) have acquired the plan for a consideration. Though the trustees clearly did not pay for the plan as each partner assigned a plan in return for the others doing the same, the assignment could be claimed to be an arrangement funded on the mutual giving of monies worth. If this view is correct, the plan falls within s210 of the Taxation of Chargeable Gains Act 1992 and the proceeds would be subject to CGT. Although opinions vary on whether this interpretation of the legislation is correct it is better to err on the side of caution and avoid assigning existing plans.

## **Assignment**

### **Can the plan be assigned back to the life assured if he leaves the partnership?**

As the life assured is a potential beneficiary of the trust, the trustees can assign the plan back to the life assured without any tax implications if they decide to leave the partnership and if they want the plan to continue as personal cover. Standard documentation can be provided to assign the plan out of trust back to the life assured personally.

# Companies

**Intermediaries who are advising corporate clients on business protection will find this section of the toolkit particularly relevant. The following pages highlight the key assets that businesses need to protect – their key people. We focus on the technical aspects of key person and shareholder protection, and cover the tax implications that may arise.**

The toolkit also explains relevant trust issues. We believe clients wishing to take advantage of the wide ranging benefits offered by our protection plans will find the information useful.

Please note: The information contained in this guide is based on our present understanding of current law and HM Revenue & Customs practice. It is not intended as a substitute for legal, taxation or other professional advice. If you have any doubts as to the legal or tax implications of the information, we recommend you seek the advice of a suitably qualified adviser.



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## Introduction

**Every day shareholders and directors take steps to protect and grow their businesses – from employing and retaining the best staff, through to listening to their customers’ requirements and insuring their business assets such as property and equipment. Decisions are made on a daily basis to protect the future of the business.**

### **But have they overlooked themselves?**

What is the potential impact to the business if a shareholder director dies or suffers a critical illness?

**Will the company be able to continue trading?**

**What will be the cost of replacing the key individual?**

**Would the surviving spouse or beneficiaries wish to remain involved?**

**What would the remaining shareholders want?**

**Would the surviving spouse wish to sell to a third party?**

**Could the remaining shareholders prevent that?**

In these unfortunate events, the potential damage to the business could be significant and unknown. Having adequate Business Protection in place resolves these issues by preparing and planning for the unexpected.

Proceeds received from Business Protection plans can be used for continuity purposes to enable the company to continue trading, replace key individuals or protect corporate debt. Alternatively, protection may be required for succession purposes with the proceeds being used to buy out a shareholder following a critical illness or their family on death.

This section of the guide will look at each of these two distinct areas in detail:

- **Corporate continuity (i.e. key person and loan protection)**

and

- **Corporate succession (i.e. shareholder protection)**

## Key person protection

### Is there a need for key person protection?

When business owners are asked what company assets are insured they always list their premises, plant and machinery, vehicles, computer equipment and so on. They recognise that cover is required for the cost of replacement, potential loss of profits and ultimately to minimise any business disruption.

However, what would happen to the company if a key employee, director or shareholder were to die or become critically ill? The cost to the company could be devastating. Consider for example the sudden death of the head engineer of a private company when it is in the process of tendering for a major project. His death could result in the loss of that contract which may be critical to the company's future survival.

### Who is a key person?

A key person is anyone whose death or disability would have a serious effect on the company's future profits. Some companies will have several key individuals, others only one, but to identify who is key requires a thorough understanding of the business itself. In some cases, it may be immediately apparent that the majority shareholder and figurehead of the company is the only key person. In other cases, one of the directors may be key despite only being a minority shareholder. The size of an individual's shareholding level is not necessarily a good indicator of who is a key person, as a non shareholding employee could easily be a key person to the business.

### How much cover is required?

#### Calculating the risk

There are no specific rules when assessing the financial value of a key person. Each key person must be dealt with on their own merits. Insurable interest must be demonstrated, and there are several options available to guide you in assessing a reasonable amount of cover. These are outlined as follows:

#### Multiple of profits

This is the primary method of calculating the key person's worth. The normal multiples are:

2 x gross profit or 5 x net profit

The profit may need to be split where there is more than one key person.

Higher multiples may be justified for a rapidly expanding business.

#### Multiple of salary

A multiple of gross salary including benefits in kind can give a useful guide to the amount needed to buy in a replacement. Up to 10 x gross salary may be considered. The disadvantage of this method is that, for other than non-shareholding employees, an accurate measure of the key person's worth to the business may not be related to their remuneration.

#### Proportion of salary roll

This method covers the key person's contribution to business turnover. It can be distorted by a shareholding director taking a low salary with a dividend as a substitute, so that profits can be reinvested, or by a director taking a relatively high salary.

The formula used would be:

$$\frac{\text{Key person's salary}}{\text{Total salaries}} \times \text{Turnover} \times \text{years to recruit and train a replacement}$$

#### Special circumstances

##### Business start up

The working capital at risk must be calculated, together with the key person's proportion of this risk.

##### Loan security

The outstanding loan will need to be covered (divided between the relevant key people as appropriate).

##### Management buyout

As in loan security the amount at risk, should they lose the key person, must be calculated.

#### Summary

There is no single solution and we will consider carefully any reasonable figure proposed.

## Writing the plan

### How should the plan be written?

As a company has its own legal identity then the company will be both the applicant and the plan owner. The life assured will be the key person.

Our business protection proposal forms allow life of another applications to be made:

- **Owner – Company**
- **Life Assured/Lives Assured – key person(s)**
- **Authorised signatories of the company will sign on behalf of the company, and the key person will also sign as life assured.**

There is no need for a trust to be used. Instead, the company owns the plan, pays the premiums and receives the proceeds.

Our Self Assurance term plans can be written with a single owner but joint lives, with payout occurring on the first event. For example, if there are two key individuals then consideration may be given to writing one joint life plan rather than two single plans. This may be appropriate, for example, where there is a company with two 50% shareholders and the company has borrowed money and now requires cover on the two shareholders so that the debt can be repaid if one of the shareholders becomes critically ill or dies. In this case, a single plan (owned by the company with joint, first event death or earlier critical illness may be appropriate).

When the company receives the proceeds then it will be its decision as to how these proceeds are used. For example they may be required to settle corporate debt or perhaps used to meet the company's financial needs while it reorganises or recruits a replacement. In the case of a critical illness claim it is possible the key person will return to work, so the funds could be used to pay a temporary replacement or replace lost profits.

Disability income benefit could also be taken out to provide a regular payment if the key person was absent through illness for any length of time. This 'income' could be used to compensate for loss of revenue, to pay a temporary replacement or to fund 'sick pay' for the key person.

## Tax implications

### (i) The key person

On the basis that the company is the owner, and the key person is simply the life assured, then there are no benefit in kind or other taxation implications on the individual. If, however, the company subsequently chooses to pay out or distribute any of the proceeds to the individual or their family then tax implications would arise on that event.

### (ii) The company

There are two aspects to consider – paying the premiums and receiving the proceeds.

#### Tax implications on paying the premiums

There is no specific provision in the tax legislation that guarantees corporation tax relief for the company. Instead, principles for the tax treatment were actually set out back in 1944 by the then Chancellor, Sir John Anderson. In answer to a parliamentary question, he made the following statement.

*Treatment for taxation purposes would depend upon the facts of the particular case and it rests with the assessing authorities and the commissioners on appeal if necessary to determine the liability by reference to these facts. I am, however, advised that the general practice in dealing with insurances by employers on the lives of employees is to treat the premiums as admissible deductions, and any sums received under a plan as trading receipts, if (i) the sole relationship is that of employer and employee; (ii) the insurance is intended to meet loss of profit resulting from the loss of services of the employee; and (iii) it is an annual or short term insurance. Cases of premiums paid by companies to insure the lives of directors are dealt with on similar lines.*

#### What does this mean?

Firstly it is clear that taxation treatment depends on the facts of a particular case and the practice of the local Inspector of Taxes. Accordingly, we strongly recommend that when a key person plan is being proposed, the company accountants or corporate tax advisers write to the company's Inspector of Taxes to gauge their views on the taxation circumstances. A binding decision on the taxation of the proceeds will not be forthcoming, but at least an insight will be gained into the likely tax outcome.

With regard to the premiums, these will be an expense charged through the profit and loss account in the annual accounts. The company will then submit those accounts to the Inspector together with the corporation tax computation. When the company is submitting this information it should highlight to the Inspector that these premiums have been paid and explain whether or not corporation tax relief has been claimed – and the rationale behind this decision. The Inspector will therefore need to make a decision as to whether they agree or not with the company on the taxation treatment of the premiums. For example, if the Inspector considers that the premiums are trading expenses, then ultimately the proceeds are likely to be viewed as a taxable trading receipt.

Please see the draft letters on the CD to HM Revenue & Customs on the taxation implications.

#### **What else can we learn from Sir John Anderson's statement?**

The proceeds will generally be taxable and the premiums tax deductible where:

##### **(i) The life assured is an employee**

In other words, no tax relief is likely on the premiums where the life assured is a shareholder. Working directors can be considered as employees (though not shareholding directors). In saying that, the Inspector may accept that a plan written on the life of a minority shareholder might pass this particular test. The logic behind this test is that for expenses to be tax allowable they must be "wholly and exclusively for the purposes of the trade....".

(s 34 ITTOIA 2005). Where a plan is written on the life of a significant shareholder, there is considered to be an element of self interest in taking out the plan (i.e. preserving your own shareholding value) and therefore the wholly and exclusively test can be failed.

##### **(ii) The insurance is to meet a reduction in profits resulting from the loss of services of the key individual**

Consider a company which borrows money to buy a factory. If the company then takes out a key person plan to repay the loan on that person's death, then the plan would not meet this criteria. It is being taken out to repay a loan, not to meet loss of profits. In addition, any plan with a surrender value will similarly fall outside this rule – the reason being that some part of the premium is going towards investment, rather than solely to meet the loss of profit. Premiums paid towards whole of life or endowment plans will therefore not qualify for tax relief.

##### **(iii) It is annual or short term insurance**

Short term is not clearly defined but is generally considered to refer to non-convertible term plans of no more than five years.

Many, if not most, plans will fail one or more of these tests and therefore the premiums will not be deemed to be tax deductible for the company.

If the plans do fail to qualify for tax relief, then does this mean that the proceeds will be received tax free?

Unfortunately not. The belief that no tax relief on premiums equates to tax free proceeds is a rule of thumb, but no more than that. Nevertheless, if the Inspector of Taxes is firmly of the view that the premiums are non trading expenses, it does make it harder for HM Revenue & Customs to state that the proceeds represent a taxable trading receipt.

HM Revenue & Customs manuals do however state that they reserve the right to tax the proceeds, even if the premiums are not allowable. An example of this would be a plan on the life of a shareholder where the purpose of the insurance is to cover for loss of profit. The Revenue could deny tax relief on the grounds that the employer/employee relationship is not met but still treat the proceeds as taxable. Their reasoning may be that if the key person had not suffered the critical illness or died then the company would have earned higher profit which would have been taxed, therefore it is logical to tax the plan proceeds intended to make up that shortfall.

##### **What about the chargeable event legislation?**

Life plans fall under the same chargeable event legislation as investment bonds. It is necessary to consider therefore if this gives HM Revenue & Customs an opportunity to tax a chargeable event gain arising in circumstances when the proceeds might otherwise escape taxation under the above principles.

Firstly, critical illness is not a chargeable event under tax legislation and therefore cannot give rise to a chargeable event gain. Therefore, it is not taxable under chargeable event legislation, but may be taxed under the general corporation tax principles outlined earlier.

Where a payout occurs on death of the life assured, then that does give rise to a chargeable event. The chargeable event gain calculation is however based on the surrender value of the plan immediately before death (less premiums

paid). It is not therefore based on the figure of proceeds actually paid out which may be considerably higher. Therefore, in most cases, no chargeable event gain will arise.

In the unlikely event that a chargeable event gain does arise, then it would be assessable on the company but with no credit given for the internal tax suffered by the life fund. Clearly, a term plan which has no surrender value cannot give rise to a chargeable event gain on death. For the avoidance of doubt, and as mentioned above, despite no chargeable event gain arising, the proceeds may still be taxable under the general corporation tax principles.

**Proceeds paid in instalments**

Both our business term and business whole of life plans contain an option at inception of the plan to receive proceeds in instalments. The details of this option are currently as follows:

Benefits may be paid in yearly instalments over three or five years with a choice between level or increasing instalments. We will increase the sum assured according to the table overleaf.

Number of yearly instalments	Increase in sum assured
3	5%
5	10%

(These increases are subject to change).

This option may be beneficial to take where it is clear that the key person proceeds will be subject to corporation tax. There are two reasons for this:

- (i) It may prevent a company normally liable to tax at small company rate (currently 19%) having to pay tax at a higher rate due to the lump sum proceeds received.
- (ii) It avoids a full tax charge on plan proceeds in year one when proceeds could be offset against the actual related expenses in later accounting periods.

The option to have benefit payments spread over a number of years should be selected at inception, otherwise HM Revenue & Customs could tax the proceeds as a lump sum on the basis that the company was entitled to the full amount.

**Disability income benefit**

Disability income plans do not fall under the above chargeable event legislation.

The general corporation tax principles outlined earlier will therefore govern the tax treatment of both premiums and proceeds.

If the proceeds are going to be used for ‘sick pay’ they are likely to be taxable for the company, but when paid out to the individual then this will be a deductible expense cancelling out the corporation tax liability. The individual will of course be taxed on this ‘pay’ in the same way as normal.

Therefore, if it is intended to use disability income benefit for ‘sick pay’ then it may be preferable for the key person to take the plan out personally. If the company pays the premiums on behalf of the individual who owns the plan, then these payments would be taxable as benefits in kind on the individual but the benefit could then be paid tax free to the individual.

## Taking your plan with you

In many instances, the company will take out key person cover and that key person will subsequently leave or retire from the company before the plan has paid out. The company may then decide to cancel the plan, as it is not then required. Alternatively, consideration could be given to gifting the ownership of the plan to that departing key person, with the individual then taking on the responsibility of paying the premiums. What are the tax implications of this? If the assignment occurs in the same tax year in which the individual leaves or retires, then the benefit in kind legislation will tax the individual on a sum equal to the cost of the benefit, i.e. the total premiums paid at the date of transfer. This could be quite costly, particularly where the plan has been running for a considerable time.

The employer however can easily circumvent this potential liability by waiting until the following tax year before assigning the plan to the individual who had left or retired (the employer having paid the premiums in the meantime). In this case, the benefit in kind legislation cannot apply. Instead, the termination of employment legislation applies such that the tax liability will be calculated on the realisable value of the plan. Typically this will be the surrender value, which could be low or even zero.

## Buyback

There is an option with our whole of life plans which allow, after a critical illness or total permanent disability claim before the 65th birthday of the life assured, for a new plan to be applied for on the life of the same life assured. The new plan may not be taken out for at least 12 months after successful discharge from cancer treatment, or at least 12 months after previous non cancer claims. The new plan will be for a term of ten years and pay a sum assured of 50% of original claim amount up to a maximum of £50,000 for a yearly premium of £25. The new plan will cover cancer, heart attack, stroke and death where the old plan included life cover.

Similarly, our term plans have a buyback option when death or earlier critical illness benefit is taken out or critical illness benefit with certain cover types. This option allows additional critical illness cover to be taken out following a critical illness or total permanent disability claim. The life assured must be under 60 when a claim is made to use this option. The 12-month time limits apply as above. The new plan will cover cancer, heart attack and stroke. The buyback plan will be for a fixed term of between five and ten years, and pay a sum assured of up to £100,000 for a yearly premium of £25.

The relevance of buyback to key person cover is that where the company selects the buyback option at outset, and subsequently receives a payout on critical illness or total permanent disability of the key person then if that individual recovers and returns to work the company can have the continued cover under the new plan for up to ten years. What happens though if the individual does not permanently return to work?

In this case, the company can assign the option to the departing individual. The individual could then take out the new plan and pay the £25 premiums on it. If the option is assigned to the individual in a tax year after he has left the company, then the realisable value of the option is subject to tax, and this should be nil.

The buyback option is available at the time you take out either death or earlier critical illness benefit or critical illness benefit. It cannot be added at a later date.

## Shareholder protection

### Is there a need for shareholder protection?

If shareholders are in any doubt as to the answer to this question, then a review of the Company's Articles of Association will highlight the need for protection to be taken out.

Every company will have a Memorandum and Articles of Association. The Memorandum is an outward looking document stating the Company name, registered office and what it will do. In contrast, the Articles of Association set out the rules for the running of the Company's internal affairs. They will therefore deal with such issues as transferring and selling shares. The Companies Act 1985 contains model articles, called Table A, which the company may adopt in whole or part.

#### What does Table A say about transferring or selling shares?

*"The directors may refuse to register the transfer of a share which is not fully paid to a person of whom they do not approve ..."*

#### What does this mean?

This means that in the event of a shareholder becoming critically ill or dying then they could sell their shares, if fully paid, to an external third party even if this was against the wishes of the other shareholders. Although this is of no comfort to the remaining shareholders, it is also of little comfort to the critically ill or family of the deceased as they may encounter difficulties in obtaining a realistic price for the shares in view of their lack of marketability. In addition, it could take months or even years to conclude a sale to a third party investor. Alternatively, the spouse of the deceased might decide to retain the shares and become involved in the business. This could be just as unwelcome for the other shareholders.

### However not all companies have adopted the model table A provisions

This is correct, and many companies will have incorporated a 'pre-emption' clause which gives the other shareholders the first opportunity to buy the shares of the critically ill or deceased. This may not offer the protection intended though. For example, how is the 'pre-emption' price per share to be computed? Is it realistic for the outgoing shareholder, and if it is a fair value how will the others raise the funds to buy out the shares? This can be especially problematic as many shareholders have little surplus cash with their wealth primarily tied up in the business. Borrowing is an option, but it should be remembered that this would be done against the backdrop of a potentially traumatic period in time where the company has lost someone who is perhaps key to the business. Any lender would take this into account when arriving at its decision to lend.

#### The solution

A shareholder protection arrangement resolves these problems. It ensures that proceeds are available when required, on death and/or critical illness of a shareholder, to ensure a speedy conclusion to the succession problem. The sudden loss of a key shareholder can disrupt a company, but shareholder protection will minimise this interruption to the business. The shareholder or their family will quickly receive the true worth of their shares to alleviate these anxious times.

### How is shareholder protection written?

There are three main methods:

1. Own life plan under business trust
2. Life of another plans
3. Company owned plan to effect buy back of shares

Each is dealt with in turn below, but firstly we will consider how the shares should be valued.

## Calculating the value

Valuing an unquoted company is a difficult task and should involve key professionals, principally the company accountants to determine the most appropriate valuation method. The Articles of Association should be reviewed to highlight any restrictions on the transfer of shares as these may adversely affect their value. In addition, the size of the shareholding itself will be a factor, with a minority holding being less valuable than a majority holding. The shareholders may however, decide to disregard any discount for a minority shareholding and instead value each shareholder's interest as a simple proportion of the total value.

There are three commonly used methods of valuing an unquoted company:

1. Multiple of maintainable profits – in this method, a 'maintainable' profit figure is arrived at by reviewing the trend of past and current performance, and considering projections of future profits. Any abnormal or non recurring items will be excluded in arriving at this maintainable figure. This figure is then multiplied by a price/earnings ratio to arrive at a capitalised earnings figure. Although the maintainable profits figure can be estimated with not too much difficulty, the real skill is in arriving at a suitable price earnings ratio.
2. Dividend Yield – this method involves the application of the level of yield a buyer might require from their investment to the actual dividend produced. This will then indicate the capitalised value or the price per share they might be willing to pay. This basis tends to be only used for minority shareholdings.
3. Net assets – net assets shown on a company's balance sheet are not necessarily a helpful guide to the valuation of shares, unless the company is, for example a property investment company.

## Own life plan under business trust

In this scenario, each shareholder takes out an own life plan for the value of his shares. This plan is then written under business trust for their co-shareholders. The aim is that if one of the shareholders suffers a critical illness or dies, then the others will receive the funds from the trust to purchase that shareholding from the ill person or the deceased's legal personal representatives. If the shareholder had died, then the personal representatives would then distribute the proceeds in accordance with the deceased's will or rules of intestacy.

Our Business Trust is a discretionary trust which includes the settlor as a beneficiary. This allows a shareholder who is leaving while their plan is still live to take that plan with them, i.e. have the plan assigned from the trustees to themselves as beneficiary. The Inheritance Tax (IHT) implications of the trust are discussed later. The life assured, as settlor of the trust, will be an automatic trustee and the additional trustees appointed will normally include the other shareholders participating in the protection arrangement. The other participating shareholders will be beneficiaries. The discretionary nature of the trust means it can adapt to changing circumstances (e.g. if a new shareholder joins the arrangement or an existing shareholder leaves). Similarly, trustees can be changed when necessary. We provide standard paperwork to assist when beneficiaries and/or trustees change.

The trustees may appoint funds to any of the beneficiaries. The discretionary beneficiaries are restricted to the shareholders, including the settlor. Non shareholding family members cannot therefore benefit.

### **How do you ensure that the others will use the proceeds to buy the shares or that the deceased's family will sell?**

To ensure that the arrangement will proceed as intended then some form of shareholder agreement is necessary. This may be a separate shareholder agreement or it may be incorporated into the Articles of Association.

## How can we help?

We provide a specimen cross option agreement. This is not an agreement which should be signed up to, but instead it is a working document which the company's legal advisors can use to draw up an agreement specific to the shareholders' requirements.

## The cross option agreement

### What is a cross option agreement?

It is sometimes referred to as a double option agreement. It gives the surviving shareholders the option to buy the shares of the deceased individual. Correspondingly, the personal representatives of the deceased also have an option to sell the shares.

If either side wishes to exercise their option, the other party must comply. Options can only be exercised after death and there will be a specific option period. Our specimen agreement gives an option period of three months but that may of course be changed by the company's legal advisors.

### Does a cross option agreement jeopardise IHT business property relief?

No. If an individual dies owning shares in an unquoted trading company then 100% business property relief may be available for IHT purposes provided those shares have been held for at least two years. Shares dealt on the Alternative Investment Market (AIM) are regarded as unquoted.

Business Property Relief will still be available despite the estate receiving cash for the shares under the terms of a cross option agreement. That's because options may only be exercised after death and the sale of the shares only becomes binding once an option has been exercised. Since there is no binding agreement to sell the shares at the date of death, Business Property Relief is preserved. This was confirmed by the Revenue in September 1996 in an article (Law Society Gazette, 4) where they stated that an option will not constitute a binding contract for sale unless it has been exercised at the time of death. This view supports the decision in a 1991 case *J. Sainsbury plc vs. O'Connor* which illustrates that a contract is unenforceable and therefore not binding in the sense of IHTA 1984 unless a party to it can claim specific performance. An option for surviving shareholders to

buy a deceased shareholder's interest is not exercisable until after death and therefore unenforceable until then. It follows that, immediately before death, the surviving shareholders' option does not constitute a binding contract for sale.

### What if the shareholders enter into a buy/sell agreement?

If they have done so, Business Property Relief would be denied.

Under this type of agreement, and while they are all still alive, the shareholders will enter into an agreement where, on the death of one of them, the remaining shareholders must buy the deceased's shareholding and the deceased's estate must sell. A life plan will therefore be taken out to finance this purchase.

The reason IHT Business Property Relief is denied is because the Revenue takes the view that at time of death a binding contract is in position where the shares will be sold by the estate and cash will come in. In substance therefore, the individual has not left shares in a private limited company for their beneficiaries but a lump sum of cash – and cash is fully subject to IHT. For this reason we do not offer a buy and sell agreement. The specimen cross option agreement (which we offer) does become binding but only after death once an option has been exercised.

### What is the position on critical illness?

It is very common for critical illness cover also to be taken out. A critically ill shareholder may not be able to contribute to the company and wish to retire.

Their fellow shareholders will require finance to buy the shares.

Critical illness may be taken out in addition to death or alternatively a death or earlier critical illness plan may be effected.

Where a business trust is being used, the critical illness plan or benefit will be written under trust in the same manner as the death benefit.

Instead of a cross option agreement, the shareholders may decide to establish a single option agreement to govern the critical illness proceeds. The reason for this is that with a cross option agreement the other shareholders could insist that the critically ill individual sells their shares following a payout on critical illness. This could be against the wishes of the individual who perhaps feel

they are able to recover and return to the business. In addition, a forced sale of shares could result in a capital gains tax liability and potentially a future IHT liability for the outgoing shareholder on the basis that they will be in possession of cash when they die. These shares may otherwise have qualified for IHT Business Property Relief.

Our specimen cross option agreement offers the shareholders the opportunity to elect for a single option on critical illness. The single option will rest with the critically ill individual. In other words, if the shareholder suffers a critical illness and the plan pays out, they have the option to insist that the others use the proceeds to buy their shares. If however, they wish to retain their shareholding, the others have no corresponding option to insist that they sell. We recognise however that in some cases the shareholders would prefer to have a double option agreement applying on critical illness. They might take this view on the basis that the 'healthy' individuals should be able to insist they buy out the critically ill person if they are perhaps of the view that they are no longer fit and able to continue as a working shareholder. Accordingly, our specimen agreement allows the shareholders to choose a double option on critical illness if that is what they would prefer.

#### **What happens to the proceeds if the single option is not exercised?**

In this situation we have a shareholder whose plan has been paid out after suffering a critical illness. However, they have then decided to remain as a shareholder instead of selling.

Our recommendation would be for the proceeds to be retained within the trust until the succession issue is resolved. Our business trust gives the trustees wide reinvestment powers. What needs to be remembered is that the purpose of the plan was to provide proceeds to buy out the individual following critical illness or death.

The temptation might be to give the critically ill shareholder some or all of the proceeds in recognition of their critical illness. But what if that person suffers a second critical illness? They will still have their shares but the proceeds may have been spent. So where will the money come from to buy them out? Similarly, the plan may have been death or earlier critical illness. The plan will only pay out on the earlier occurrence of critical illness. If the shareholder then dies, where is the money to buy the shares from their estate?

Another reason for not distributing the proceeds when the shares are not being sold is because it would involve proceeds being used for a non commercial purpose.

This could demonstrate to the Revenue that the shareholder protection arrangement is not fully commercial. And as noted below IHT implications could arise in the future.

#### **Are there any disadvantages to leaving the proceeds in trust?**

It is important to be aware of the potential impact of the Pre Owned Asset Tax charge (POAT) which was introduced in the 2003 Pre Budget Statement and came into effect on 6 April 2005.

This is a charge to income tax which applies where an individual can benefit from an asset which they previously owned. The new charge is designed to counter IHT planning arrangements which by pass the Gift With Reservation of Benefit provisions yet still allow the donor to benefit from the asset given away. The tax charge applies to the annual benefit enjoyed by the individual. The method of valuing the annual benefit varies depending on the type of asset. However no tax charge will arise where the annual benefit is £5,000 or less. Where the annual benefit exceeds this amount, it's added to the individual's other income for the tax year and is subject to tax at their marginal rate.

As already mentioned, POAT is designed to combat certain IHT planning schemes. Unfortunately the use of business trusts for shareholder protection purposes fall foul of these provisions since they include the settlor as a potential beneficiary (by virtue of them being a shareholder in the business). The trust is not caught by the Gift With Reservation of Benefit provisions as it is part of a commercial arrangement. However, the POAT charge does apply as there is no similar exclusion under the new legislation.

In most cases though, any annual benefit would be within the de minimus limit of £5,000. Since the trust asset is a life policy, the annual benefit will currently be calculated as 6.25% of the 'open market value' of the policy. While the life assured is in good health the open market value should be negligible. Therefore the charge shouldn't apply.

Where it may become an issue for the settlor is if they suffer from a critical or terminal illness and the funds sit in the trust for any period of time (e.g. if they decide not to sell their shares in the company). In that case the value of the trust fund will be considerably higher and therefore 6.25% may exceed the de minimis limit.

Any potential tax charges can be avoided if the settlor is removed as a potential beneficiary from the trust. This can be done using our standard deed to remove the settlor which is included on the CD.

There may also be IHT implications as discussed in the next section, **'IHT implications of the business trust'**.

## Tax implications

### **IHT implications of the business trust**

Our Business trust is a discretionary trust which means if a new shareholder arrives they can join the share protection arrangement at that time and become a beneficiary of these earlier trusts. Beneficiaries should not include non participating family members as this would lead to the arrangement being categorised as non commercial. The life assured can be a potential beneficiary and the trust will not be treated as a gift with reservation. Having the life assured as a potential beneficiary ensures that if that individual were to leave the company, then it is a straightforward procedure to have the plan assigned out of the trust to the beneficiary. They may then use it for personal purposes. We can supply the paperwork to achieve this.

The reason the trust can be considered as not giving rise to a gift with reservation is that where each shareholder takes out a plan and writes it under trust for the other participating shareholders with an appropriate option agreement in force, then this represents a reciprocal commercial arrangement. On this basis there is no element of gratuity or gifting and therefore no gift with reservation issues arise.

### **What are the implications of using a discretionary business trust?**

The trust is subject to the 'relevant property' regime applying to discretionary trusts. In theory this regime can result in immediate IHT payable on lifetime transfers into trust plus 'periodic' charges at every 10th anniversary and 'exit' charges on capital distributed between 10

year anniversaries. In a business context however, the payment of premiums will not be treated as gifts or lifetime transfers where they are made as part of a property commercial arrangement. With regard to the 10th anniversary charges, then typically these will not apply for life cover given that following a death claim, the funds will normally be paid out of the trust immediately to the other partners in order that they can purchase the partnership share of the deceased. Accordingly funds are rarely sitting in trust at a 10th anniversary. In the unlikely event that they are, then the excess of the proceeds (or indeed the surrender value of the life policy should the individual be in very poor health at that time) over the available nil rate band will be subject to IHT at 6% on current rates. A more common scenario would be a case where critical illness cover was taken, and the partner chooses not to sell their business interest and the critical illness proceeds remain in trust beyond the 10th anniversary of the trust's creation. If so, periodic and exit charges might well arise unless the trustees decided to release the funds from the trust and for the other partners to then hold this money personally.

### **Can more be done to improve on or reinforce the commerciality?**

Yes. Shareholder premiums can be 'equalised'. The term equalisation simply relates to each shareholder paying a commercial amount relative to their expected benefit. If premiums are not equalised then the differing amounts paid caused by differences in age, health and size of stake in the company could be deemed gifts which introduces IHT implications. Consequently, gift with reservation implications could arise, given that business trusts include the settlor as a potential beneficiary. If this is the case, premiums might be deemed gifts for IHT purposes, although in practice, possibly exempt due to the availability of the individual's annual IHT exemption, or normal expenditure out of income exemption. More seriously however, the sum paid into the trust on death could be subject to IHT under the gift with reservation principles. In contrast, a properly commercial arrangement would be free of IHT. It should be noted that simply using a Gift Trust rather than a Business Trust as a means of avoiding gift with reservation issues is unlikely to succeed. The reason is that a discretionary gift trust would include beneficiaries who are not shareholders and therefore the trust would lack commerciality and may then give rise to a gift with reservation by associated operations.

A simple illustration of the need for equalisation would be a company with two equal 50% shareholders. Each takes out a plan in trust for the other, but shareholder A's premiums are considerably more than shareholder B's premiums due to Shareholder A's age and health. In this example, A is paying more but ultimately is less likely to benefit from the arrangement as they are more likely to die. Therefore A is effectively making gifts to B and as such gift with reservation implications could arise on death. In this scenario, premium equalisation would simply involve B paying A's premium and vice versa. In this way each would be incurring costs relative to their expected benefit. The individuals concerned should therefore come to an agreement to settle these differences. For example, they may process the adjustments through their directors' loan accounts with the company, or even a suitably documented transfer through their personal bank accounts.

If more than two individuals are involved then a mathematical calculation can be used. For example, if there are three participating shareholders then the following formula could be used to work out shareholder A's equalised share of premiums to be paid:

Sum assured on A x B's premium	+	Sum assured on A x C's premium
Total sum assured – sum assured on B		Total sum assured – sum assured on C

The same principle would be applied for shareholders B and C.

A premium equalisation spreadsheet can be found on the CD.

#### Can I put an existing plan into the business trust?

Although it can be done, we would not recommend it for the following reason.

Proceeds from life assurance policies are not subject to capital gains tax unless the plan is in second hand ownership and the second hand owner acquired the plan for money or money's worth. Where a plan is put into trust it will be in second hand ownership. It is therefore important to ensure that the transfer into trust is not for money or money's worth. In a business protection arrangement, it is clear that no money is being paid, but could it be construed as a transfer for money's worth? Our understanding is that in view of the fact that each shareholder is assigning their plan into trust, in return for

the others doing likewise then this could be viewed as a money's worth transaction. We consider it better practice therefore to establish the trust before the plan goes on risk to avoid this.

#### Key points of own Life plans written under business trust

1. Trust is a discretionary trust
2. The beneficiaries of the trust will be the other participants in the share protection arrangement. Non participants should be unable to benefit from the trust
3. The flexible nature of the trust ensures that it can deal with changing circumstances (i.e. joiners and leavers).
4. Typically those involved in the share protection arrangement will be trustees
5. It should be accompanied by an agreement governing the transfer of the shares. Typically this will be a cross option agreement on death and single option on critical illness
6. If the settlor suffers a critical illness and does not wish to sell his shares then those proceeds are best retained in and reinvested within the trust until the succession issue is resolved
7. The trust should be established at outset

#### Life of another plans

Each shareholder takes out a plan on the life of their co-shareholders. In one respect this is very simple as it does not involve a trust. In addition, no premium equalisation is involved as you are not paying a premium reflecting your personal circumstances.

#### What problems arise from life of another plans?

Firstly, multiple plans can arise. For example, a four shareholder company could require twelve plans, i.e. Shareholder A takes out plans on each of the lives of B, C and D, and so on. In addition, this arrangement is inflexible where shareholders join or leave.

Broadly, therefore, it is most suitable for companies with two shareholders where it is unlikely that new shareholders will become involved.

Even with a two-shareholder company, life of another might be problematic where critical illness is involved. Consider the case of shareholder A who has a death or earlier critical illness plan on shareholder B. If B were to suffer a critical illness, then A would receive the proceeds as plan owner. If B decides to sell, B transfers his shares to A in return for the proceeds. But what if B has a single option and decides to remain a shareholder. The situation then is that A is left with the proceeds in their own personal estate. This is clearly not as attractive as the trust solution where the proceeds may be retained within the security of the trust and a unanimous decision must be taken by the trustees before the proceeds can be distributed.

#### Key points on life of another plans

1. Cumbersome where more than two shareholders are involved
2. Premium equalisation not required
3. No trust required but option agreement still necessary
4. Problems may arise with single options on critical illness

### Company buy back of own shares

Under this method, first permitted in 1981, the company will take out plans on each of the participating shareholders. The company will be the owner of the plans and the shareholders will be the lives assured. The plans are therefore life of another and no trusts are required. The Companies Act 1985 legal requirements must then be satisfied before the buy back can take place.

Please note that The Companies Act 2006 has now become law. Its provisions however will only be brought into force in stages with all of it in effect by October 2008. The following notes therefore reflect the position at the time of writing.

The company will pay the premiums and receive the proceeds in respect of the life and/or critical illness plans on the shareholders lives. The intention of this method is that the company may then use these proceeds to buy the shares from a shareholder who has died or become critically ill. An appropriate cross option/single option type agreement should be in force between the company and the outgoing shareholder or their legal personal representatives. Given that various Companies

Act requirements have to be met before the buy back can proceed, the option agreement in place will have less certainty than an agreement between individual shareholders.

#### Example

Five Engineering Ltd has an authorised share capital of 100 shares, issued as follows:

	Shares
Mr A	20
Mr B	20
Mr C	20
Mr D	20
Mr E	20
	<hr/> 100

The company takes out five death or earlier critical illness plans on each of the shareholders. Mr. A dies and the company buys back his shares from his estate and in the process cancels them. The situation is now as follows:

The authorised share capital of Five Engineering Ltd remains 100. This now comprises:

Issued shares	80
Unissued shares	20
	<hr/> 100
Mr B	20
Mr C	20
Mr D	20
Mr E	20
	<hr/> 80

Prior to the scheme buy back, each shareholder had a one fifth interest (20/100). This has now increased to one quarter (20/80). The 20 cancelled shares may be re-issued in the future if required. This also highlights a potential problem with the company buy back solution where there is a shareholder, for example a private equity investor, who has a stake but does not wish to increase that shareholding. In that case, if the plans were instead set up as own life under business trusts, that investor could be removed as a potential beneficiary of the trusts so that their shareholding remains constant while the others are involved in purchase/sale of shares.

### **Why is this considered potentially tax efficient?**

If the company is the plan owner, then although the premiums will not be eligible for corporation tax relief, they will not be taxable as a benefit in kind on the individual. This is in contrast to the situation where shareholders take out own life plans and the company pays those premiums. In this case, the premiums paid will constitute benefits in kind for the individual.

### **Will the proceeds be subject to corporate tax?**

The proceeds should not be subject to corporate tax in view of the fact that the plan is being taken out for a capital rather than trading purpose. For a detailed discussion on the taxation of life or critical illness plan proceeds received by companies, see the key person section at the start of this guide. Companies must seek advice from their own legal advisers.

### **Legal requirements**

The Companies Act 1985 sets out specific requirements to be met for a valid buy back of shares. The key points are as follows:

- (a) The Company's Articles of Association must give it the authority to effect the purchase. If they do not, for example companies formed prior to 1981 (when the old 1948 Companies Act was in force), then the shareholders will need to pass an appropriate special resolution enabling it to do so.
- (b) On purchase, the shares must be treated as cancelled and the company's issued share capital (although not its authorised share capital) must be diminished by the nominal value of those shares.
- (c) Most purchases will be 'off market' (i.e. broadly those not purchased on a recognised investment exchange). As such, any contract must be authorised or a proposed 'contingent purchase' must be approved in advance by a special resolution. A 'contingent purchase' contract is a contract under which the company may become entitled or obliged to purchase the shares. In other words, a type of option agreement.  
  
A special resolution requires a 75% majority by those entitled to vote who do so in person (or by proxy, if allowable) at a general meeting.
- (d) A private company must use distributable profits to purchase the shares before it can resort to capital.

Additional safeguards are required where the purchase is to be made out of capital, as may be the case where the purchase is funded from life plan proceeds. In particular:

- The directors must make a statutory declaration under Form 173, specifying the amount of the capital payment for the shares in question and stating that the payment can be made without prejudice to the company's creditors. In particular, they must confirm that they can see no grounds on which the company would be unable to pay its debts or continue as a going concern for a period of at least one year after the purchase. This declaration must be accompanied by an auditor's report backing it up. The statutory declaration should be delivered to the Registrar of Companies no later than the notice date specified below. This could be a significant issue to take into account when considering the company purchase route since the proceeds of any plan paid to the company on the death of a shareholder will normally be treated as a capital receipt. The requirement for a statutory declaration could mean that when the sum assured is paid, it has to be used for purposes other than share purchase thus thwarting the purpose for which the plan was implemented.
- A special resolution authorising the purchase of the shares out of capital with the approval of 75% of the remaining members present and voting should be passed within one week of the statutory declaration.
- Within one week of the special resolution, a notice must be placed in the London Gazette making creditors aware that the payment out of capital has been, or is to be, made. It must give the creditors a chance to apply to the court to cancel the resolution. At the same time, a similar advertisement has to be inserted in a national newspaper and a copy of the statutory declaration and the auditor's report must be delivered to the Registrar of Companies. Where a company has substantial debts, its creditors may well object to the company capital being spent on share purchase if this could, in their view, prejudice their interests.
- The share purchase must take place between five and seven weeks from the date of the special resolution authorising it.

- Form 169 – Return by a Company Purchasing its own Shares – must be completed and delivered to the Registrar of Companies within 28 days from the date shares purchased by the company are delivered to it.

### **Tax treatment of the sale and purchase of the shares**

The tax treatment of buy backs is unusual as the rules treat the buy back payment as a distribution (i.e. a dividend) unless the payment falls within S219 TA 1988 in which case the buy back will represent a disposal for CGT purposes.

If the dividend treatment applies, any excess proceeds received over the original subscription price will be treated as investment income. Higher rate income tax liabilities could therefore arise on the critically ill shareholder or his beneficiaries in the event of their death.

If however, the conditions are met for the CGT treatment to apply then the excess over the original subscription price will give rise to a capital gain. This is usually advantageous:

- (i) If shares are repurchased after death, then shares will have been revalued at time of death which means that any capital gain is generally eliminated, unless the proceeds received exceed the market value at date of death.
- (ii) If shares are repurchased on critical illness, then outgoing shareholder may mitigate the gain with business taper relief and, availability of his/her CGT exemption.

### **Conditions to be satisfied for capital treatment to apply**

1. The company must be an unquoted trading company or the holding company of a trading group. This must be the case when the purchase is taking place. Investment companies, including those dealing in shares, securities, land or futures are excluded.
2. The purchase is made wholly or mainly for the purpose of benefiting the trade carried on by the company or any of its 75% subsidiaries. According to HM Revenue & Customs Statement of Practice SP2/82 the sole or main purpose of a purchase must be to benefit a trade and the following circumstances may lead to the test being satisfied.
  - a) Resolution of a disagreement over management
  - b) Withdrawal of equity finance by an outside shareholder
  - c) Retirement of a controlling shareholder who is retiring as a director and wishes to make way for new management
  - d) Death of a shareholder when the personal representatives desire to sell the shares
3. It will be obvious that in many cases the 'benefit' anticipated is of such a nature that it can only be secured if the shareholder is bought out completely. A disposal of all of the vendor's shares, as opposed to merely reducing his holding, would be more likely to result in the test being satisfied. The retention of a small holding by the vendor, however, say for sentimental reasons, should not in itself cause the loss of the capital gains tax treatment.
4. The transaction should not be part of a scheme or arrangement made to avoid tax.
5. The vendor must be resident and ordinarily resident or treated as resident and ordinarily resident in the UK.
6. The vendor should normally have held the shares for at least five years. If the personal representatives are selling the shares, the qualifying period is reduced from five to three years. This is an important issue where shareholders of a newly started company are planning for share purchase protection.
7. The vendor's shareholding must be substantially reduced. This test is satisfied if the fraction of the company's issued share capital owned by the vendor is reduced by more than 25% as a result of the sale. It is not sufficient merely for the vendor's shareholding to be reduced by 25%.
8. After the sale the vendor must not be connected with the company. This, together with the benefit of trade requirement, generally means that the vendor cannot merely sell off a few of his shares.

Under S225 ICTA 1988, there is a procedure for advance clearance to be obtained from the Revenue that the capital treatment will apply. The Revenue has 30 days to respond. In addition S707 ICTA 1988 clearance can be obtained for companies controlled by five or fewer persons in view of the fact that capital is leaving the company.

Following share purchase, the company must make a return to its Inspector (under S226 ICTA 1988) if it has bought its shares back under the capital procedures. This must be done within 60 days of purchase regardless of whether clearance was requested.

#### **Effect on share values**

The receipt of plan proceeds by the company and corresponding increase in the company's assets could clearly have an upward effect on share values. However, if the deceased director was a key member of the company, it could be argued that their death or departure would have a downward effect on share valuation. Whatever price may be specified by the option agreement, for inheritance tax purposes, the payment of a sum assured is a change occurring by reason of the death of the life assured. The result is that the sum assured would be an asset of the company for the purposes of share valuation on the death of a shareholder (S171 IHTA 1984). Indeed, at any given time, the market value of the plans effected by the company would be included among its assets. Our specimen option agreement specifies that the purchase price should be the value of the shares immediately before death. This means that only the market value of the plan would be included in the company's assets. This could be substantial however if the life assured were in ill health at the time. Subject strictly to any professional advice that may be received, the agreement should specify that the purchase takes place at market value as it is possible that a sale at any other price could result in HM Revenue & Customs withholding clearance.

Any inheritance tax consequences would usually be minimised or completely avoided due to business property relief.

#### **How do you ensure that the company will use the proceeds to buy back the shares or that the deceased's family will sell?**

To make sure that the arrangement proceeds as intended, some form of shareholder agreement is necessary (as with own life in trust and life of another plans).

#### **How can we help?**

We provide a sample cross option agreement (available on the CD) specifically drawn up for company buy backs. As explained earlier, the option agreement we provide is not intended for signature but instead should be used as a working document which the company solicitors can use to finalise an agreement specific to the particular circumstances. Also our specimen agreement offers the opportunity to select a single option on critical illness.

#### **Key points on company buybacks**

1. Requires company owned plans on the lives of the shareholders. No trust required.
2. Premiums should be non allowable and proceeds tax free. No benefit in kind implications arise.
3. Companies Act legal requirement to be met before a valid buy back can be effected.
4. When the company pays out the proceeds to the critically ill shareholder or their estate, this may be treated as a dividend or as a capital amount. The specific circumstances will dictate which treatment will apply. Procedures exist for advance clearance.
5. Premium equalisation not required.
6. Option agreement necessary.

## Wills

All the shareholders involved in the shareholder protection arrangement should execute wills to ensure their intended beneficiaries receive the proceeds free of any intestacy delays. Those involved should also bear in mind that their shares will typically qualify for 100% Business Property Relief for IHT purposes. As explained earlier, shares in an unquoted trading company which have been held for at least two years will qualify for this relief. If this is the case, and the proceeds from the share protection arrangement are left under the terms of the will to the surviving spouse/civil partner, the relief has effectively been wasted since the survivor will then hold cash which is fully subject to IHT in the event of their subsequent death.

Where business property relief is available, the proceeds of the share purchase arrangement may be left to a will trust. In this way, the relief can be 'crystallised'.

A discretionary trust will allow a range of beneficiaries, including the surviving spouse/civil partner, to obtain benefits from the trust. In the meantime the trust fund will not fall within their estate for IHT purposes. In addition to the potential IHT savings, the trust may keep the funds outside of the survivor's estate for long term care purposes.

We offer a By Pass trust for consideration by the individual's solicitors (available on the CD). This is a discretionary trust where the shareholder's children and spouse/civil partner will be included amongst the discretionary beneficiaries. The trustees can then pay income, capital or even make loans to any of the beneficiaries, including the spouse. The trust will be taxed under the relevant property regime outlined earlier.



# The complete business kit for advising your clients

## Here's a CD to help

Inside, you'll find all sorts of tools to help you sell Business Protection to your clients. As well as highlighting potential solutions to a number of typical issues facing your clients, it includes sample documents, such as letters, trust forms, sales aids and presentations. There's also a premium equalisation tool to work out premium payment examples.

Why not take a look – it could save you a lot of time and effort.



### MINIMUM SYSTEM REQUIREMENTS



#### Windows

Win98, Pentium II, 64MB, Win2K, Pentium III, 128MB, WinXP, Pentium III, 128MB, Microsoft Internet Explorer 6sp1, 5.5sp2, 5.01sp2, Netscape 7.1



#### Macintosh

Power Macintosh G3, OS 9.2, 64 MB RAM, Microsoft Internet Explorer 5.1, Macintosh OS X, Power Macintosh G3 running OS 10.1.5, 10.2.6, 10.3, 10.4 128 MB RAM, Microsoft Internet Explorer 5.2 or later, Netscape 7.1, Safari.

Scottish Provident cannot accept responsibility for any disruption, damage and/or loss to your data or computer system that may occur when using this CD.

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