

Taking care of business

Your ultimate guide to business protection

Protection | Business Menu Plan



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Any business, large or small, is likely to face the unexpected at sometime. But your clients can reduce their risk by planning ahead.

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

Help protect your clients against the unexpected by recommending business protection from Royal London.

For details of Relevant Life Plans please refer to our guide to Relevant Life Plans.

Partnerships, LLPs and sole traders

If you're advising partnerships, LLPs and sole traders on key person and ownership protection, you'll find this section particularly helpful.

The following pages highlight the importance of protecting key people. We look at the technical aspects of business protection, and show you how you can work with your clients to establish the most appropriate level of cover. The guide also explains how to deal with the various tax implications of protecting a business.

Introduction to business protection

Partnerships and LLPs

People are critical in small businesses. If an owner or key employee dies or falls ill, the impact on the business can be huge. The immediate concern will be to make sure the business can carry on running until a replacement can be found, or until the colleague comes back to work. Cashflow can become a major headache.

While sales may fall, expenditure continues and the business's main priority will be to make sure that there's enough cash to meet its outgoings.

Business protection lets owners plan for the unexpected by providing cover so that the business can keep running with minimal disruption.

For partnerships, there's another aspect which is just as important but is often overlooked.

In most circumstances, a partner will leave their assets, including their interest in the business, to family members. Business protection allows the other partners to regain control of their business if one of them were to die.

For LLPs the existence of a membership agreement will be important. If there's no agreement, the Limited Liability Partnership Act 2000 will dictate what happens.

If a member dies and their interest passes to someone else, the other person will be entitled to receive anything that would have been due to the member.

Business protection addresses issues such as:

- What is the true value of the business?
- Should the value include any goodwill?
- Where will the remaining owners find funds to buy the interest?
- If they can't buy the interest, 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'll want to know:

- How can they make sure they get a fair value for the interest in the business?
- How long will it take for the other partners or members to buy out their share?

These issues don't just arise if someone dies. If a partner or member suffers a critical illness, they may well decide to retire and will look to receive a fair value for their interest.

A partnership or membership protection scheme can easily resolve problems like this by providing:

1. An agreement setting out how interests in the business should be valued and allowing the remaining partners or members the right to buy someone's interest.
2. The funds to buy the interest.

Partnership or membership protection and key person protection are often confused. It's important to establish why the cover is needed to make sure the proceeds fall into the right hands.

Key person protection

Is there a need for key person protection?

When business owners are asked what business or partnership assets they insure, they always list their premises, plant and machinery, vehicles, computer equipment and so on. They know they need cover 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, member or owner, in the case of a sole trader, 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 a business is in the process of tendering for a major project. Their death could result in the loss of that contract which may be essential to secure the future 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, members, senior employees or the owner.

There will always be at least one key person in any given business.

However, clients should also consider the impact of losing someone who may not have any financial stake in the business but nevertheless plays a fundamental role in its success.

You can find out who the key people are 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 that depend on the key person?

Calculating the cover

Once you've identified the key people, the next step is to establish the level of cover needed. There are no hard and fast rules when assessing the financial value of a key person. But there are several ways you can assess a reasonable amount of cover:

Multiple of profits

This is the main way of calculating a key person's worth. As key person cover is concerned with protecting the profitability of the business, considering profit is a sensible first step. The normal multiple is:

- 5 x net profit

The profit may need to be split where there's 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 or member, a multiple of gross salary, including benefits in kind (P11D benefits), can give a useful indication of the amount needed to bring in a replacement. This might be up to 10 times gross salary for life cover and up to 5 times gross salary for critical illness cover.

Proportion of salary roll

An alternative for employees is to calculate the key person's contribution to turnover as shown in the formula below.

It will usually take at least a year to train and recruit a replacement, but in some cases it could take three or even four years.

Special circumstances – business start-up

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

Other considerations

If the business owners have provided security personally, this may also need to be covered to protect their dependants.

Summary

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

Key person's salary				
Total salaries	x	Turnover	x	Years to recruit and train a replacement

Which type of cover?

Key person protection is intended to cover future loss of profits so 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 a good option. The business can choose to have the cover payable as a lump sum or possibly by instalments. However, depending on who the key person is, their involvement with the business may not last until retirement. So perhaps shorter term cover would be better.

Another option is Whole of Life. Although this isn't the obvious choice for key person protection, it can have advantages for a founding or managing partner who has no intention of retiring in the short to medium term. Even if the key person leaves, it may be a good idea to assign the plan to them. The tax implications of doing so are covered later in the guide.

The most appropriate type of cover to choose can often depend on the comparative costs of the premiums and the tax implications.

Writing the plan

Whatever type of cover is chosen, it's important to remember that the plan should be set up for the business to ultimately receive the proceeds.

Partnerships

For partnerships, there's a potential problem with ownership. In England, Wales and Northern Ireland, a partnership is not a separate legal entity in its own right. So it can't take out a key person plan. However, the key person could insure their own life and place the plan under trust for the benefit of all the partners in the business. We offer a specimen business trust for this purpose. For this set-up the plan should be written in trust from inception.

A Scottish partnership is a separate legal entity. So the plan can be set up as life of another with the business as both owner and beneficiary.

Limited liability partnerships

A limited liability partnership (LLP) is halfway between a limited company and a partnership. It's a legal entity in its own right, completely separate from its members and is registered with the Registrar of Companies. The liability of the members is limited to the amount subscribed for the LLP and any personal guarantees given.

However, for taxation purposes, the individual members are treated as if they're self employed individuals, just as if the LLP was a partnership with individual members paying tax on any income and/or gains. 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 more key person plans aren't written is because of uncertainty over the tax treatment of premiums and benefits. The only guidelines we have on the tax treatment were set out in 1944 by the then Chancellor of the Exchequer, Sir John Anderson, who said:

'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's an annual or short term insurance.'

What does this mean in practice?

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. Employer/employee relationship

The relationship must be that of employer/employee. If the person covered has a significant stake in the business, relief wouldn't normally be allowed. The logic behind this test is that for expenses to be tax allowable they must be 'wholly and exclusively for the purpose of trade...'. Where a plan is written on the life of a partner or member, there may be an element of self interest in taking out the plan (that is, preserving the value of their interest in the business) and therefore the wholly and exclusively test can be failed.

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 won't qualify for relief on the grounds that it's 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's no clear definition as to what constitutes short term assurance but it's generally accepted this means five years. Five-year renewable insurance is usually allowable. Longer terms could be justified provided they don't exceed the period of usefulness of the employee to the company.

Can these tests be relied on?

These rules are for guidance only. The application of these tests can depend on the facts of the case so we recommend that the business or their accountant will write to the local inspector of taxes when the plans are being set up to confirm the tax treatment.

What about any proceeds paid out under the plan?

The tax treatment of the premiums can also have a bearing on the tax treatment of the proceeds. If the premiums have qualified for tax relief as a business expense, the proceeds will usually 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 person covered is solely a key employee and not a partner. In all other cases,

generally the proceeds will be paid into a trust for the partners individually and then paid into the business as capital introduced by the partners or members 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 the profit share of each partner will increase and the proceeds taxed on them accordingly at their highest rates of tax. In the past it may have been possible to reduce the impact of tax by arranging for cover to be paid in instalments over a number of years. However, under current generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) requirements it's unlikely that this would be successful as the liability to tax will arise in full on claim.

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

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 tax 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'll be taxed on any gains at their marginal rate. The partners could 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's extremely unlikely that a gain will arise as the surrender value before 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 Income Protection be included?

Premiums paid on income protection are unlikely to be tax deductible for the partnership or LLP. If the person covered is a partner or member, 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 or members as drawings if paid directly to the business. The partners can agree to forego profits for periods of incapacity, but this could be reimbursed through Income Protection.

If the plan has been placed in a business trust, Income Protection is a retained benefit, which means it's payable to the partner or settlor of the trust. It can be agreed that while the benefit is being paid to the partner to provide sick pay, the business doesn't need to pay the partner profits.

However, if the person covered 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's intended to use the payment as sick pay for the employee it could be better 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 be paid out tax free to the individual on claim.

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

Unless the plan is taken out to cover sick pay, the answer is no. The benefit in kind rules don't apply to partners. Any premiums paid by the business on behalf of the partners will simply reduce their outstanding capital accounts, that is, 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 Income Protection).

Assignment

Can the plan be assigned back to the key person personally if the business no longer needs it?

If the person covered is a partner, the plan can be assigned to them personally with no tax implications.

However, the position for an employee is different as the assignment could be treated as a benefit in kind for the key person and may give rise to capital gains tax if there's a claim. We recommend seeking professional tax advice before any assignment.

Key person protection for sole traders

Who needs to be insured?

1. The sole trader

The sole trader is the business, so they need to protect the profits in the event of their death, critical illness or sickness. Given there's no distinction between them and their business, cover for this purpose will be written as personal protection.

If the cover is solely for 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 Life Cover. If the sole trader dies, their 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. They could take out Income Protection to compensate for lost profits or find a temporary replacement.

2. An employee

The sole trader may also want to insure the life of one or more of their key members of staff. Such a plan would normally be established on a life-of-another basis, with the sole trader being the owner and the person covered 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.

Tax

Tax relief won't be due where the person covered is the sole trader, as there's 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 person covered is a key employee, the same tests as 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 repay a business loan in the event of the death or critical illness of a partner, member or sole trader, the tax 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, it wouldn't meet the 'wholly and exclusively' test under section 34 ITTOIA 2005, which means it's unlikely that tax relief will be given on premiums.

Where the cover is designed to repay a partnership loan, usually the partners concerned take out own Life Cover and place it under a business trust for the other business partners. In the event of a claim, they would receive benefits from the trust and 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 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 (HMRC tax bulletin February 1992).

Partnership and membership protection

Why is there a need for partnership or membership protection?

A partnership

A partnership is defined in section 1 of the Partnership Act 1890 as ‘the relationship which subsists between persons carrying on business in common with a view of profit’.

The definition excludes companies or associations registered under the companies acts. 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 that partner’s interest is based on their share of the assets of the business.

A limited liability partnership (LLP)

A LLP is a form of legal entity, which is a corporate body formed in accordance with the provisions of the Limited Liability Partnership Act 2000. Each member has an interest in the business, rather than ownership of ordinary shares.

If there’s no membership agreement, section 7 of the Act provides that where a member has died, their personal representatives may not interfere in the management of the business. However, they’re still entitled to receive whatever the member would have been entitled to.

Valuing the partnership or membership interest

The valuation of a partnership or membership interest can be difficult and so we strongly recommended that the partnership or LLP has a formal agreement which sets out how this value will be established and, in the case of the partnership, allows the business to continue in the names of the remaining partners.

Family interests

In the event of the death of a partner or member, 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’ll usually want to withdraw their share of the capital. Having partnership protection in place means that the family can receive a fair value for that interest.

Partners’ or members’ interests

The surviving co-owners will continue to run the business with a sleeping partner or member taking a share of the profits. So they’ll be keen to pay the family their share of the business back as soon as possible.

Partnership or membership protection means that the partners or members will have sufficient funds to do this.

To be effective, a partnership or membership 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 make sure 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 or membership protection arrangement should be to consider the individual partners’ or members’ own personal wills.

Why is a personal will relevant to partnership or membership protection?

It's important to find out who will inherit the interest in the business.

The next step is to consider the timing of any potential purchase of that interest by the other partners or members. It's in the interests of both the family and the other partners or members to have probate granted on the estate as soon as possible and buy the business interest. A valid, up-to-date will can help to achieve this.

However, the main reason for reviewing the partners' or members' wills before setting up a partnership or membership protection arrangement is to make sure each of the wills is tax efficient.

In particular it's important to make sure full advantage is taken of any business property relief (BPR) that may be available for inheritance tax (IHT) purposes. BPR is a valuable relief which is available on transfers of business property. It's subject to certain conditions being satisfied, both as to the type of business and the period the interest has been held. 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 are shown below. No relief is generally given where a rent is charged for an asset owned personally but used for business purposes.

A business or an interest in a business (including a partnership share)	100%
Shares in unquoted companies (includes AIM shares)	100%
Controlling shareholdings in quoted companies (more than 50% of voting rights)	50%
Land or buildings or plant and machinery used in a business of which the person covered was a partner at the date of death or used by a company they controlled	50%

The bypass trust

A bypass trust is a discretionary trust established in the will of the partner or member. On the partner or member's death, the value of the business interest would be left to the trustees of the bypass trust to hold in trust for the beneficiaries. No IHT charge will arise at that point if BPR is available. The partner or member can decide who the beneficiaries should be.

In practice, if a partnership or membership protection arrangement has been established in their lifetime, the other partners or members can buy out the interest in the business and the payment can then be placed into the bypass 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. The benefit of a bypass trust is that it avoids the proceeds of the sale enlarging the surviving spouse or civil partner's estate on death, thereby potentially reducing the exposure to IHT.

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 or members.

The partnership or membership agreement

A surprisingly large number of partnerships and LLPs have no partnership or membership 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 or LLP, retirement, death or ill health of any of the partners or members.

Any existing partnership or membership agreement must be reviewed before recommending or arranging partnership or membership protection plans to make sure there's no conflict. There are three main types of agreements that are generally used for partnership or membership protection purposes. These can either be incorporated into the main partnership or membership 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. Regardless of the type of agreement, they should all include the following main points:

- Names and addresses of the partners or members entering into the agreement.
- Details of the business.
- An undertaking to make sure there's always enough cover.
- An agreement to review level of cover regularly.
- Details of how and who will value the business.
- A fallback should there be a shortfall in plan proceeds to meet the cost of the share of the business, that is, how will any balance be paid?

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

Automatic accrual

This type of agreement is only available to partnerships and LLPs and it doesn't involve an actual sale or purchase of the share of the business. Instead, an agreement is entered into whereby the partnership is allowed to continue on the death of a partner and the share in the business automatically passes to the remaining partners.

In the case of an LLP, the member's interest automatically passes to the surviving members. The estate doesn't receive any payment for their interest in the partnership or LLP.

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 or LLP, by way of compensation for their families. Each plan would normally be placed in trust for the benefit of family members so that the proceeds would be outwith the estate for IHT purposes.

If all partners or members do this then no IHT liability should arise on the premiums paid where they're 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 or member's share of the business, the agreement would normally require the surviving partners or members 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 or members.

Buy and sell agreement

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

To finance this, generally each partner or member will have an obligation to take out Life Cover on his own life and write it in trust for the benefit of fellow partners or members. Or, they may be required to take out 'life of another' plans on the lives of their fellow partners or members. 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's 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. So under the IHT Act 1984 s 113, the partner or member's interest in the business is not deemed to be business property and so doesn't qualify for the relief.

Cross-option agreement

This agreement is similar to the buy and sell agreement, but the surviving partners or members 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 or members 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 or member, 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.

What if critical illness is included?

Critical Illness Cover for partnership or membership protection can be as important as Life Cover.

Critical illness can often result in a partner or member withdrawing from the business. Any of the agreements we've outlined can accommodate a transfer or sale if someone gets a 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 can't then be forced out if they feel they'd be able to return to the business once they've recovered.

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

A single option can also be appropriate in the case of a terminal illness, as it means that the affected partner or member can't be forced out of the business. Although they can opt to sell their share if they wish, they can choose to keep it 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?

This depends on the individual circumstances. Automatic accrual is simple and so it's 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. The cross-option agreement is generally believed to be the most tax efficient. We can provide a sample cross-option agreement but you should always seek separate legal advice.

Valuing the business

All of the above agreements will usually specify how, when and by whom the business should be valued. The client's accountant will usually be involved in finding the most appropriate method of valuation to use. Partnerships in particular can be difficult to value as much of the value will relate to goodwill.

Common ways to value partnerships and LLPs are:

Average partnership profits

The objective is to reach a figure for the maintainable profits for the business. This usually involves reviewing 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. It's not uncommon to use a factor of between three and six for this purpose.

Goodwill

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

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's important to review it regularly to make sure there's 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 needed to be paid to the other partners or members 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 cover be written on a life of another basis or on own life under business trust?

Writing a plan as life of another is the simplest option as it doesn't involve trusts or equalisation of premiums. Premium equalisation is covered in more detail later in this guide. However, if there are a number of partners or members it can mean there are lots of different plans in place.

If, for example, there are four partners then each partner would need 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 of which the partner or member is the applicant and the person covered, and then place it in trust for the benefit of their fellow partners or members, it does have some major advantages.

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

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

Another reason why the trust route may be the preferred option is if critical illness is included in the plan. If the person covered 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, that is, the other partner(s)/member(s). The partner or member who has suffered the critical illness will have no control over the proceeds.

However, if they've set up 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 to make sure the transaction is commercial, premiums need to be 'equalised' so that each partner or member pays a commercial amount relative to the benefit they may receive (IHT Act 1984 s10).

If premiums are not equalised, then the difference in premiums paid (caused by the partners' or members' differences in age, health and size of stake in the business) could be deemed transfers of value for IHT purposes. This may not matter if the difference is small, because of annual IHT exemptions.

However, the position in the event of a claim can be more dramatic. In this case, the arrangement wouldn't be completely commercial or in other words would involve gifts. This then raises the possibility of an IHT charge on the proceeds under the gift with reservation legislation.

For a three-man partnership the

formula shown below would be used to work out partner A's equalised share of premiums to be paid. 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.

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 came into effect on 6 April 2005.

This is a charge to income tax which applies where a person can benefit from an asset they used to own. The charge is designed to counter IHT planning arrangements that bypass the gift with reservation of benefit provisions, yet still allow the settlor to benefit from the asset given away. The tax charge applies to the annual benefit they enjoy.

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. If it's more than £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.

Unfortunately, using business trusts for partnership or membership protection falls foul of the POAT provisions since they include the settlor as a potential beneficiary (by virtue of them being a partner or member in the business). The trust isn't caught by the gift with reservation of benefit provisions as it's part of a commercial arrangement but a POAT charge may apply as there's no similar exclusion under the legislation.

Having said that, in many cases any annual benefit would be within the limit of £5,000. Since the trust asset is a protection policy, the annual benefit will be calculated as 2%* of the 'open market value' of the policy. While the person covered is in good health the open market value would be negligible, so the charge should not apply.

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

* this is the official rate of interest, which may be subject to change

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 length of time (for example, if they decide not to sell their business interest). In that case, the value of the trust fund will be considerably higher and so 2% may exceed the 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 specimen deed.

We generally recommend that the settlor should only be removed as a beneficiary when a payment is to be made to allow flexibility within the trust to assign the plan back to them should they leave the business.

What type of trust do we offer?

We offer a specimen business trust drawn up on a discretionary basis. The beneficiaries in the trust must be the co-business owners. The person covered can be a potential beneficiary and the trust won't be treated as a gift with reservation. The reason for this is that, where premiums are equalised, no actual gift is made as it's purely a commercial transaction. As there's no intention to make a gift, there can be no gift with reservation.

Tax implications

Is there any tax relief available on premiums?

The premiums will be paid directly by each partner out of their taxed income. If the partnership or membership pays the premiums on behalf of the partners they will be shown as drawings from the partners' or members' capital accounts.

Is there an income tax liability on plan proceeds?

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 before 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. 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.

However, in a business context the payment of premiums won't be treated as gifts or lifetime transfers where they're made as part of a commercial arrangement. Typically, the 10th anniversary charges won't 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 or members.

As a result, funds are rarely sitting in trust at a 10th anniversary. In the unlikely event that they are, then the excess (or indeed the actuarial value of the Life Cover 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 a partner with Critical Illness Cover chooses not to sell their business interest and the critical illness proceeds stay in trust beyond the 10th anniversary. 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 or members to then hold this money personally.

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

The sale price will usually be made up of two elements. The first will relate to repayment of the partner's or member'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 or member's share of capital and profits which have already been taxed. However, goodwill is a chargeable asset for capital gains tax (CGT) purposes.

No CGT would normally arise on the death of the partner or member as the interest in the business is usually sold shortly afterwards by the estate and there's 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 disposal relief (formerly known as entrepreneurs' relief) which may apply and deduction of any available annual exemption.

Is there any problem in using existing plans?

Partners or members 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 didn't hold the plan and that the current owners (the trustees) have acquired it for consideration.

Though the trustees clearly didn't 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 section 210 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 right, it's better to err on the side of caution and avoid assigning existing plans.

Assignment

Can the plan be assigned back to the person covered if he leaves the partnership or LLP?

As the person covered is a potential beneficiary of the trust, the trustees can assign the plan back to them without any tax implications if they decide to leave the partnership or LLP and if they want the plan to continue as personal cover. We can provide specimen documentation to assign the plan out of trust back to the person covered.

The trust provides that if the partner leaves the business, the trustees must hold the trust benefits for the partner or member, even if the plan isn't assigned out of trust.

Companies

If you're advising corporate clients on business protection, you'll find this section of the guide particularly helpful.

The following pages highlight the importance of protecting key people. We look at the technical aspects of key person and shareholder protection, and cover the tax implications that may arise.

The guide also explains relevant trust issues.

Introduction to business protection

For companies

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' needs and insuring their business assets.

But have they overlooked themselves?

- What might happen to the business if a shareholder/director died or suffered a critical illness?
- Would the company be able to continue trading?
- What would be the cost of replacing a key person?
- Would the surviving spouse or beneficiaries want to become involved?
- Would they want to sell to a third party?
- What would the remaining shareholders want?

Having adequate business protection in place could help resolve these issues.

The payout from a business protection plan could enable the company to continue trading, replace key people or protect corporate debt. Alternatively, it could be 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 distinct areas in detail:

- Corporate continuity
(key person and loan protection)
- Corporate succession
(shareholder protection).

Key person protection

Is there a need for key person protection?

When business owners are asked what company assets they insure, they always list their premises, plant and machinery, vehicles, computer equipment and so on. They know they need cover 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's 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 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 key to the business.

How much cover is needed?

Calculating the cover

There are no specific rules when assessing the financial value of a key person. Insurable interest must be demonstrated, and here are several ways you can assess a reasonable amount of cover:

Multiple of profits

This is the main way of calculating a key person's worth. As key person cover is concerned with protecting the profitability of the business, considering profit is usually the first step.

The normal multiple is:

- 5 x net profit

The profit may need to be split where there's more than one key person. It would be apportioned according to contribution. 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 bring in a replacement. This might be up to 10 times gross salary for life cover and up to 5 times gross salary for critical illness cover. The disadvantage of this method is that for 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 is shown below.

Key person's salary					
Total salaries	x	Turnover	x	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).

Where there are multiple applications for directors in the same company, it may be possible to allow cover for 100% of the commercial loan on each life, (limits may apply). For further details, please contact us.

Management buyout

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

Venture capital

Some businesses raise capital through private equity or venture capital firms. The capital investment would be calculated and covered as appropriate.

Summary

There's no single solution and we'll consider any reasonable figure proposed.

Writing the plan

As a company has its own legal identity, it will be both the applicant and the plan owner. The person covered will be the key person. Our application forms allow life of another applications to be made as follows:

- Owner – company
- People covered – key person(s)
- Authorised signatories will sign on behalf of the company, and the key person will also sign as the person covered

There's no need to use a trust. Instead, the company owns the plan, pays the premiums and receives the proceeds.

Our plans can be written with a single owner but joint lives, paying out on the first event.

For example, if there are two key people one joint life plan may be better than two single plans. This may be appropriate, for example, if a company with 2 x 50% shareholders has borrowed money and now needs cover so that the debt can be repaid if one of the shareholders falls critically ill or dies.

When the company gets the proceeds it can then decide how to use them. For example, they may be needed 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's possible the key person will return to work, so the funds could be used to pay a temporary replacement or replace lost profits.

Income Protection could also be taken out to provide a regular payment if the key person was off for any length of time. This 'income' could be used as compensation 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 person covered, then there are no benefit in kind or other taxation implications. However, if the company subsequently chooses to pay out or distribute any of the proceeds to the person covered or their family, then there would be tax implications.

(ii) The company

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

Tax implications on paying the premiums

There's no specific provision in the tax legislation that guarantees corporation tax relief for the company. Instead, principles for the tax treatment were set out back in 1944 by the then Chancellor of the Exchequer, 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's an annual or short term insurance.'

What does this mean?

Taxation treatment depends on the facts of a particular case and the practice of the local inspector of taxes. So we recommend that the company accountant or corporate tax adviser writes to the local inspector of taxes to gauge their views on the tax treatment.

A binding decision may not be forthcoming, but perhaps they'll gain an insight into the likely tax outcome.

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.

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 person covered is an employee

In other words, no tax relief is likely

on the premiums where the person covered is a shareholder. Working directors can be considered as employees (though not shareholding directors). However, 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 purpose of trade....'. Where a plan is written on the life of a significant shareholder, they consider there to be an element of self interest in taking out the plan (that is, preserving your own shareholding value) and so 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 person

Consider a company which borrows money to buy a factory. If a company then takes out a key person plan to repay a loan on that person's death, then the plan wouldn't meet this criteria.

Any plan with a surrender value will similarly fall outside this rule because some part of the premium is going towards investment, rather than solely to meet the loss of profit. Premiums paid towards Whole of Life Plans with a surrender value 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. Longer terms could be justified provided they don't exceed the period of usefulness of the employee to the company.

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

If the plans fail to qualify for tax relief, 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.

HM Revenue & Customs manuals 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. HMRC 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. So they tax the plan proceeds intended to make up that shortfall.

Loan relationship rules

The 2008 Budget brought company owned protection plans within the scope of the 'loan relationship' rules. The only types of policy excluded from these provisions are protection plans where there can't be a surrender value (for example, term assurance policies).

This means that any increase in the value of the plan, shown in the company's accounts, in excess of the premiums paid would be subject to corporation tax.

Where a company holds an existing protection plan which is not a term policy, it will be treated as surrendering that policy on the first day of the accounting period.

The Finance Act states that 'if the amount or value of a lump sum payable under an investment life contract by reason of death or the onset of critical illness, exceeds the surrender value of the contract immediately before the time when the lump sum becomes payable, the excess is not to be brought into account as a credit...'. In other words, any gain from death or critical illness is excluded from the loan relationship tax provisions (this mirrors the chargeable event legislation).

The loan relationship rules are complex and generally the company's accountant will advise.

What about the chargeable event legislation?

Company owned Whole of Life Plans generally fall within the loan relationship rules and so this section is only relevant for term assurance policies or Whole of Life Plans that don't have a surrender value.

Protection plans fall under the same chargeable event legislation as investment bonds. This may give HM Revenue & Customs an opportunity to tax a chargeable event gain arising in circumstances when the proceeds might otherwise escape tax under the above principles.

Firstly, critical illness is not a chargeable event under tax legislation and so can't give rise to a chargeable event gain. This means it's not taxable under chargeable event legislation, but may be taxed under the general corporation tax principles outlined earlier.

If a policy pays out on death of the person covered, that does give rise to a chargeable event. The calculation is based on the surrender value of the plan immediately before death (less premiums paid). It's not based on the proceeds actually paid out which may be considerably higher. So, 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 can't give rise to a chargeable event gain on death. Despite no chargeable event gain arising, the proceeds may still be taxable under the general corporation tax principles.

In the past it may have been possible to reduce the impact of tax by arranging for cover to be paid in instalments over a number of years. However, under current generally accepted accounting principles (GAAP) and international financial reporting standards (IFRS) requirements it's unlikely that this would be successful as the liability to tax will rise in full on claim.

Income Protection

These plans don't fall under the chargeable event legislation. The general corporation tax principles outlined earlier will govern the tax treatment of both premiums and proceeds.

If the proceeds are going to be used for sick pay, they're likely to be taxable for the company. But when paid out to the person covered, this will be a deductible expense cancelling out the corporation tax liability. They will of course be taxed on this 'pay' in the same way as normal.

So, if this cover is intended to be used for sick pay, it may be better for the key person to take the plan out personally. If the company pays the premiums on behalf of the person who owns the plan, these payments would be taxable as benefits in kind (P11D benefit) on the individual but the benefit could then be paid to them tax free.

Taking your plan with you

In many instances, a key person will leave or retire from the company before the plan has paid out. The company may then decide to cancel the plan, as it's not then needed. Alternatively, they could gift the plan to the key person, who then takes on the responsibility of paying the premiums.

What are the tax implications of this?

The assignment could be treated as a benefit in kind for the key person and may give rise to a capital gains tax liability in the event of a claim, depending on the circumstances of the assignment. So we recommend taking professional tax advice.

Shareholder protection

Is there a need for shareholder protection?

If shareholders are in any doubt, a review of the company's articles of association will highlight the need for protection.

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. So they'll deal with issues like transferring and selling shares.

The Companies Act 2006 contains provision for the Secretary of State to prescribe model articles which the company may adopt in whole or part. These model articles are now set out in the Companies (Model Articles) Regulations 2008 but only apply to companies formed on or after 1 October 2009. For companies formed before this the previous table A articles set out in the Companies Act 1985 may apply.

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 if a shareholder becomes critically ill or dies, 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. It may be difficult to get a realistic price for the shares in view of their lack of marketability. And, it could take months or even years to conclude a sale to a third party investor.

Alternatively, the spouse or family of the deceased might decide to keep 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.

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 calculated? Is it realistic for the outgoing shareholder and if it's a fair value how will the others raise the funds to buy out the shares?

Borrowing is an option, but 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 deciding whether to lend.

The solution

A shareholder protection arrangement resolves these problems. Funds would be available when they were needed, on the death and/or critical illness of a shareholder. 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 plans under business trusts.
2. Life of another plans owned by the shareholders.
3. Company owned plans to buy back shares.

Each is dealt with in turn, but firstly we'll look at how the shares should be valued.

Calculating the value

Valuing an unquoted company is difficult. Key professionals, principally the company accountants, should determine the most appropriate valuation method to use after reviewing the articles of association to highlight any restrictions on the transfer of shares.

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 ways to value an unquoted company:

1. Multiple of maintainable profits

A maintainable profit figure is reached by reviewing the trend of past and current performance, and considering projections of future profits. Any abnormal or non-recurring items will be excluded. This figure is then multiplied by a price/earnings ratio to arrive at a capitalised earnings figure.

2. Dividend yield

This method involves applying the level of yield a buyer might require from their investment to the actual dividend produced. This will then give a 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 valuing the shares, unless the company is, for example a property investment company.

Own life plans under business trust

In this scenario, each shareholder takes out an own life plan for the value of their 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 buy their shares. If the shareholder has died, the personal representatives would distribute the sale 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, that is, have the plan assigned from the trustees to themselves as beneficiary.

The inheritance tax (IHT) implications of the trust are discussed later. The person covered, as settlor of

the trust, will be an automatic trustee and the additional trustees appointed will normally include the other shareholders taking part in the protection arrangement.

Because the trust is discretionary, it can adapt to changing circumstances (for example, if a new shareholder joins the arrangement or an existing shareholder leaves). Similarly, trustees can be changed. We provide a specimen form to help with a change of trustees.

The trustees may appoint funds to any of the beneficiaries. The discretionary beneficiaries are restricted to the shareholders, including the settlor.

How do you make sure that the others will use the proceeds to buy the shares or that the deceased's family will sell?

We recommend a 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 to sign, but instead is a draft document which the company's legal advisers could use to draw up an agreement specific to the shareholders' requirements.

The cross option agreement

What is a cross-option agreement?

This is sometimes referred to as a double option agreement. It gives the surviving shareholders the option to buy the shares from the personal representatives.

If either side wants 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 a period of three months but the company's legal advisers may of course change that.

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

No. If someone dies owning shares in an unquoted trading company, 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 treated as unquoted.

Business property relief will still be available despite the estate getting cash for the shares under the terms of a cross-option agreement. That's because options can only be exercised after death and the sale of the shares only becomes binding once an option has been exercised.

Since there's no binding agreement to sell at the date of death, business property relief is preserved. This was confirmed by HMRC in September 1996 in an article (Law Society Gazette, 4) where they stated that an option won't 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 so 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 so unenforceable until then. It follows that, immediately before death, the surviving shareholders' option doesn't constitute a binding contract for sale.

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

Business property relief would be denied.

While they're all still alive, the shareholders will enter into an agreement where, on the death of one of them, the remaining shareholders must buy the shareholding and the estate must sell. Life cover will be taken out to finance the purchase.

The reason they won't get business property relief is because HMRC 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. So, the shareholder hasn't left shares in a private limited company for their beneficiaries but a lump sum of cash – and cash is fully subject to IHT.

This is why we don't offer a specimen buy and sell agreement. Our specimen cross-option agreement does become binding, but only after death once an option has been exercised.

What's the position on critical illness?

A critically ill shareholder may not be able to contribute to the company and may want to retire.

Their fellow shareholders will need finance to buy the shares.

Where a business trust is being used, a plan that includes critical illness cover will be written under trust in the same way as a plan with only life cover.

Instead of a cross-option agreement, the shareholders may decide to set up a single option agreement. The reason for this is that with a cross-option agreement the other shareholders could insist that the critically ill shareholder sells their shares following a payout on critical illness. This could

be against the wishes of the shareholder who may feel they're able to recover and return to the business.

A forced sale of shares could result in a capital gains tax liability and potentially a future IHT liability for the outgoing shareholder because they'll have 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 shareholder. In other words, if the shareholder suffers a critical illness and the plan pays out, they have the option to insist the others use the proceeds to buy their shares.

If they want to keep their shareholding, the others have no option to insist that they sell. However, in some cases the shareholders may prefer to have a double option agreement for critical illness, so that they can buy out the critically ill person if they feel they're no longer fit and able to continue.

Our specimen agreement allows the shareholders to choose a double option on critical illness if they want.

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 but they've decided not to sell.

We recommend the proceeds to be kept within the trust until the succession issue is resolved. Our business trust gives the trustees wide reinvestment powers.

Although they might be tempted to give the critically ill shareholder some or all of the proceeds, the purpose of the plan was to provide proceeds to buy out a shareholder following critical illness or death. What if they suffer a second critical illness? Where will the money come from to buy them out? Similarly, the plan may have been for life or 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 HMRC that the shareholder protection arrangement is not fully commercial. Which means IHT implications could arise in the future.

Are there any disadvantages to leaving the proceeds in trust?

It's important to be aware of the potential impact of the pre-owned asset tax charge (POAT) which came into effect on 6 April 2005.

This is a charge to income tax which applies where someone can benefit from an asset they used to own. The charge is designed to counter IHT planning arrangements that bypass the gift with reservation of benefit provisions yet still allow the settlor to benefit from the asset given away. The tax charge applies to the annual benefit they enjoy. 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. If it's more than £5,000, it's added to the individual's other income for the tax year and is subject to tax at their marginal rate.

Unfortunately, using business trusts for shareholder protection purposes falls 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's part of a commercial arrangement. However, the POAT charge does apply as there's no similar exclusion under this legislation.

In most cases though, any annual benefit would be within the limit of £5,000. Since the trust asset is a Life Plan, the annual benefit will be calculated as 2%* of the 'open market value' of the policy. While the person covered is in good health the open market value should be negligible, so 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 length of time (for example 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 so 2%* may exceed the 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 specimen deed. There may also be IHT implications as discussed in the next section, 'IHT implications of the business trust'.

Special circumstances

There are circumstances where a typical cross-option agreement won't be appropriate. For example, where two sets of spouses are shareholders in a business and one spouse from each set is more involved in the business than the others.

Consider the following:

A,B,C and D are each 25% shareholders in a company. A and C are more active in the business than B and D. If either A or C were to leave the business through death or critical illness, their respective spouses would want to leave too, even though they could stay in the business. However, if B or D were to die, A or C would want to receive their spouse's shares and continue running the business.

Generally, cover would be arranged on the lives of A and C respectively, with the sums assured equal to the total combined value of their shareholdings and their spouses'. For example, if A's shares are worth £250,000 and B's shares are worth £250,000, the total amount of cover on A's life will be £500,000.

As the shares of B and D would pass to their surviving spouses in their wills, there's no need for protection on their lives.

A cross-option agreement would be put in place to enable C and D (or just C if D dies first) to buy A and B's shares on A's death or critical illness and the opposite in respect of C's shares.

We can provide a draft specimen cross-option agreement that the clients' solicitor could use to draw up an suitable agreement specific to your clients' requirements. Their solicitor can also help make sure that their wills are up to date.

* This is the official rate of interest, which may be subject to change.

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 and become a beneficiary of these earlier trusts. The person covered can be a potential beneficiary and the trust won't be treated as a gift with reservation. Having the person covered as a potential beneficiary means that if they were to leave the company, the plan can be assigned out of the trust to the beneficiary. They can then use it for personal purposes. We can supply the paperwork for this.

The reason the trust doesn't give rise to a gift with reservation is that where each shareholder takes out a plan and writes it under trust for the other shareholders with an appropriate option agreement in force, this represents a reciprocal commercial arrangement. So there's no element of gratuity or gifting.

What are the implications of using a discretionary business trust?

The trust is subject to the 'relevant property' regime applying to discretionary trusts. This 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.

However, in a business context the payment of premiums won't be treated as gifts or lifetime transfers where they're made as part of a proper commercial arrangement.

Typically, the 10th anniversary charges won't apply for Life Cover given that following a death claim, the funds will normally be paid out of the trust immediately to the other shareholders. As a result, funds are rarely sitting in trust at a 10th anniversary. In the unlikely event that they are, then the excess (or indeed the surrender value of the Life Cover 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 a shareholder with Critical Illness Cover chooses not to sell their shares and the critical illness proceeds stay in trust beyond the 10th anniversary. If so, periodic and exit charges might well arise unless the trustees decided to release the funds from the trust and for the other shareholders to then hold this money personally.

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

Yes. Shareholder premiums can be 'equalised'. This means each shareholder pays a commercial amount relative to their expected benefit. If premiums are not equalised, 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. As a result, gift with reservation implications could arise, given that the specimen business trust includes the settlor as a potential beneficiary.

If this is the case, premiums might be deemed gifts for IHT purposes. In practice, they may fall within the individual's annual IHT exemption, or normal expenditure out of income exemption.

More seriously, 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. Simply using a gift trust rather than a business trust as a means of avoiding gift with reservation issues is unlikely to succeed. This is because a discretionary gift trust would include beneficiaries who are not shareholders and so the trust would not be commercial 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 2 x 50% shareholders. Each takes out a plan in trust for the other, but shareholder A's premiums are considerably more than shareholder B's because of A's age and health. In this example, A is paying more but is less likely to benefit from the arrangement as they're more likely to die.

So A is effectively making gifts to B which means there could be gift with reservation implications 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 people concerned should agree how they want 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 people are involved, a mathematical calculation can be used. For example, if there are three shareholders taking part, the formula shown below could be used to work out shareholder A's equalised share of premiums to be paid. The same principle would be applied for shareholders B and C.

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

Can I put an existing plan into the business trust?

Although it can be done, there are some implications you should be aware of.

Proceeds from protection plans are not subject to capital gains tax unless the plan is in secondhand ownership and the secondhand owner acquired the plan for money or money's worth. Where a plan is put into trust it will be in secondhand ownership. So it's important to make sure the transfer into trust is not for money or money's worth.

In a business protection arrangement, no money is being paid, but could it be construed as a transfer for money's worth? Because each shareholder is assigning their plan into trust, in return for the others doing likewise, this could be viewed as a money's worth transaction.

Key points of own life plans written under business trusts

1. The trust is discretionary.
2. The beneficiaries of the trust will be the others taking part in the share protection arrangement. Non-participants shouldn't be able to benefit from the trust.
3. The flexible nature of the trust means it can deal with changing circumstances (that is, joiners and leavers).
4. Typically those involved in the share protection arrangement will be trustees.
5. The trust 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 doesn't want to sell their shares, the proceeds are best kept in and reinvested within the trust until the succession issue is resolved.
7. The trust should be set up at outset.

Life of another plans owned by shareholders

Each shareholder takes out a plan on the life of their co-shareholders.

In one respect this is very simple as it doesn't involve a trust. And there's no premium equalisation involved as the shareholders are not paying premiums reflecting their personal circumstances.

What problems arise from life of another plans?

Firstly, it could mean having many plans. For example, a four shareholder company could need 12 plans, that is, shareholder A takes out plans on each of the lives of B, C and D, and so on. This arrangement is inflexible where shareholders join or leave.

Broadly, those plans are most suitable for companies with two shareholders where it's unlikely that new shareholders will become involved. Even with a two-shareholder company, life of another might cause problems where critical illness is involved.

Consider the case of shareholder A who has a Life or Critical Illness Cover on shareholder B. If B were to suffer a critical illness, A would receive the proceeds as plan owner. If B decides to sell, B transfers his or her shares to A in return for the proceeds.

But what if B has a single option and decides to remain a shareholder? A is then left with the proceeds in their own personal estate. This could cause potential IHT issues in A's estate. So this is not as attractive as the trust solution where the proceeds may be kept within the security of the trust.

Key points on life of another plans owned by shareholders

1. Cumbersome where more than two shareholders are involved.
2. No need for premium equalisation.
3. No trust needed but agreement still necessary, usually a cross-option agreement.
4. Problems may arise with single options on critical illness.

Company buyback of own shares

Under this method, first permitted in 1981, the company will take out plans on each of the shareholders taking part. The company will be the owner and the shareholders will be the people covered. The plans are life of another and no trusts are needed. The Companies Act 2006 legal requirements must then be satisfied before the buyback can take place.

The company will pay the premiums and get the proceeds of the life and/or critical illness plans on the shareholders' lives. The company can 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 buyback can proceed, the option agreement 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
A	20
B	20
C	20
D	20
E	20
Total	100

The company takes out five Life or Critical Illness plans on each of the shareholders. 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
Total	100

B	20
C	20
D	20
E	20
Total	80

Before the scheme buyback, 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 needed. This also highlights a potential problem with the company buyback solution where there is a shareholder, for example a private equity investor, who has a stake but doesn't want 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 potentially tax efficient?

If the company is the plan owner, then although the premiums won't be eligible for corporation tax relief, they won't be taxable as a benefit in kind on the person covered. 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 corporation tax?

The proceeds should not be subject to corporation tax because the plan is being taken out for a capital rather than trading purpose. For more on the taxation of life or critical illness cover proceeds received by companies, see the key person section at the start of this guide. We recommend companies seek advice from their own legal advisers.

Legal requirements

The Companies Act 2006 sets out specific requirements to be met for a valid buyback of shares. The key points are summarised:

- The company's articles of association must not prevent the purchase.
- 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.

- Most purchases will be 'off market' (that is, 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.

- A private company must use distributable profits to purchase the shares before it can resort to capital.

Extra safeguards are needed if the purchase is to be made out of capital. For example, where the purchase is funded from protection plan proceeds. The company's accountant should be able to confirm the correct treatment at the time of any purchase. If a purchase using the plan proceeds is to be treated as a capital payment, the requirements can be summarised as follows:

- The directors must make a statement in accordance with section 714, 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 statement must be accompanied by an auditors' report backing it up.

The statement 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 may be treated as a capital receipt.

The requirement for a statutory statement 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 set up.

- 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 statement.
- Within one week of the special resolution, a notice must be placed in the Gazette making creditors aware that the payment out of capital has been approved. The creditors may apply to the court to cancel the resolution. At the same time, a similar advertisement has to be put in a national newspaper or written notice given to each creditor and a copy of the statement and the auditors' 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 SH03 – return of purchase of 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.

For full details of these requirements see part 18, chapters 4 and 5 of the Companies Act 2006.

Tax treatment of the sale and purchase of the shares

The tax treatment of buybacks is unusual as the rules treat the buyback payment as a distribution (that is, a dividend) unless the payment falls within s1033 Corporation Tax Act 2010 in which case the buyback 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. This means higher rate income tax liabilities could therefore arise on the critically ill shareholder or their beneficiaries in the event of their death.

However, if 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. There are advantages to this:

- If shares are bought back after death, then they will have been revalued which means that any capital gain is generally eliminated, unless the proceeds received exceed the market value at date of death.
- If shares are bought back on critical illness, then the outgoing shareholder may mitigate the gain with any available business asset disposal relief and any annual CGT exemption.

Conditions to be satisfied for capital treatment to apply.

1. The company must be an unquoted trading company or the unquoted 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.

However, if the seller keeps a small holding (not exceeding 5% of the issued share capital), say for sentimental reasons, this should not in itself cause the loss of the capital gains tax treatment.

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. HMRC guidance on the trade benefit test can be found in HMRC Statement of Practice 2/82. It includes the examples of when the test may be satisfied summarised below:

- Resolution of a disagreement between the shareholders over management that's having or is expected to have an adverse effect on trade.
- Withdrawal of equity finance by an outside shareholder.
- Retirement of a controlling shareholder who is retiring as a director and wants to make way for new management.

- Death of a shareholder when the personal representatives want to sell the shares.
3. The transaction shouldn't be part of a scheme or arrangement made to avoid tax.
 4. The seller must be resident and ordinarily resident in the UK in the year the purchase is made.
 5. The seller must 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 may be an important issue where shareholders of a newly started company are planning share purchase protection.
 6. The seller's shareholding must be substantially reduced. This test is satisfied if the fraction of the company's issued share capital owned by the seller is reduced by more than 25% as a result of the sale. It's not enough merely for the seller's shareholding to be reduced by 25%.
 7. After the sale, the seller mustn't be connected with the company. This, together with the benefit of trade requirement, generally means that the seller can't merely sell off a few of their shares.

Under s1044 Corporation Tax Act 2010, there's a procedure for getting advance clearance to be obtained from HMRC that the capital treatment will apply.

Following share purchase, the company must make a return to its inspector (under s1046 CTA 2010) 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 plan proceeds and corresponding increase in the company's assets could clearly increase the company's share value.

However, it could be argued that losing a key person would have a downward effect. 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 person covered.

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 if the person covered were in ill health at the time. Subject to any professional advice, the agreement should specify that the purchase takes place at market value as it's 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 make sure that the company will use the proceeds to buy back the shares or that the family will sell?

You could use some form of shareholder agreement (as with own life in trust and life of another plans).

How can we help?

We provide a sample cross-option agreement specifically drawn up for company share purchase. 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 prepare an agreement specific to the clients' particular circumstances. Our specimen agreement offers the opportunity to select a single option on critical illness.

Key points on company share purchase

1. Requires company owned plans on the lives of the shareholders. No trusts needed.
2. Premiums should be non-allowable and proceeds tax free*. There are no benefit in kind implications.
3. Companies Act legal requirement to be met before a valid buyback can be effected.
4. When the company pays out the proceeds to a critically ill shareholder or their estate, this may be treated as a dividend or as a capital amount.

The specific circumstances will determine which treatment will apply. There are procedures for advance clearance.
5. No need for premium equalisation.
6. Option agreement usually needed.

* Subject to HMRC confirmation.

Wills

All the shareholders involved in the shareholder protection arrangement should write wills to make sure their intended beneficiaries get the proceeds without any intestacy delays. 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 when they then die.

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 get benefits from the trust. In the meantime the trust fund won't 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.

A bypass trust is a discretionary trust where the shareholder's children and spouse/civil partner will be included among the discretionary beneficiaries. The trustees can then pay income, capital or even make loans to any of the beneficiaries. The trust will be taxed under the relevant property regime outlined earlier. The trust would be included as part of the shareholder's will or as a codicil.



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