Macbeth

Shareholder Protection

Why should the owners of a business consider this type of arrangement?

In order that control of the business remains with the surviving owners, rather than passing to someone who is unwilling or unable to contribute to the running of the business, while ensuring that the deceased's beneficiaries are provided for.

What is a cross/double option agreement?

A cross/double option agreement gives the surviving owners the option to purchase the deceased's interest in the business, and the personal representatives of the deceased the option to sell to the surviving owners. If either party chooses to exercise their option, the agreement becomes binding.

Why do 'own life' life policies need to be placed under trust?

If the policies were not placed in trust, the proceeds would be paid to the deceased's estate. The surviving owners of the business require these funds in order to meet their obligations under the double option agreement. This will be achieved by an appropriately worded trust.

Are there any circumstances in which a trust is not required?

Where there are only two owners of a business, and only ever likely to be two, they may decide to effect life policies on each other's lives (on a 'life of another' basis). This still ensures the correct person, i.e. the surviving owner, receives the sum assured under the life policy, but without the need for a trust.

Where owners of the business are closely related, HM Revenue & Customs (HMRC) may judge that a business protection arrangement involving trusts is not a purely commercial arrangement. This risk can be avoided by effecting 'life of another' policies. In any other case where 'life of another' policies are used, e.g. effected by the partners jointly, a trust would be inappropriate.

Is there anything the owners of a business can do to support an argument that their arrangement is commercial?

Again, there are no fixed rules, but the following factors would support such an argument:

- All relevant individuals should be included on the appropriate basis.
- Legally binding agreements are in place.
- New partners/shareholders are included as appropriate.
- The sum assured under each life policy should match the life assured's full interest in the business.

The fact that the owners of the business are of different ages or have different sized interests in the business (resulting in different costs for providing their respective life cover) should not by itself result in the arrangement losing its commercial status. However, where trusts have been effected, the participants may wish to redistribute the costs of the arrangement so that the cost borne by each individual more closely reflects his prospects of benefiting from the arrangement.

What are the tax implications of a business protection arrangement?

As mentioned previously, provided the arrangement is classed as 'commercial' there will be no Inheritance Tax consequences for the settlors of the life policies in trust. The deceased owner's interest in the business will fall into their estate for IHT purposes. However, depending on the nature of the business, Business Property Relief would normally be available.

No Capital Gains Tax liability should arise unless the value of the deceased's interest in the business increases between the dates of death and sale by more than the sellers' available exemptions.

There should be no Income Tax on the proceeds of the term assurance policy as there are no investment gains. However, if a trust (existing or new) allows the settlor to benefit, it will fall within the scope of the pre-owned assets tax legislation, effective from 6 April 2005.

Can the business pay for the premiums under the life policies?

Yes. However:

- If the business is a company, the directors will be assessed to both tax and national insurance (provided earnings are below upper earnings limit) on the premium amounts. The company will be liable to employer's national insurance on the contribution, but this and the cost of the premium itself may be an allowable deduction against Corporation Tax.

Why is a single option recommended for critical illness purposes?

There is the possibility that the owner will make a full recovery and wish to return to work. They may also want to avoid a potential CGT charge on disposal of their share, or not wish to lose Business Property Relief which may be available on their interest in the business but would not if sold. If a double option agreement has included critical illness the other owners of the business could force the ill person to sell their share. This situation can be avoided by ensuring a single option is included to cover critical illness.