AWFM Fact File

"Director/Partner Share Protection"

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This issue is relevant to you if you run a business in partnership with one or more people. It is relevant in family businesses as well, although generally not when it is just a husband and wife.

The dream of many is to set up a business, which both sustains a good lifestyle but also releases a "retirement" value to the business owners at some point in the future. Regrettably but sadly inevitably, some business owners never reach retirement, but die or become seriously ill before ever truly reaping the financial rewards of their business.

The problem
In a business which is owned by more than one individual, if in one of the shareholders were to die, ordinarily the *shares* of that individual will pass to the deceased's estate. Let us assume this is the deceased's spouse who knows nothing about the day to day running of the business. Two main problems exist here:

1. The spouse can exert influence on the business as they now control a portion of the business, and;
2. The business will probably be struggling financially due to the loss of the key individual but the non-contributing spouse will be seeking to get some income or capital out of the business, if the deceased had not provided sufficient life insurance cover.

The solution
To ensure that the deceased's estate (spouse probably) receives the full value of the shareholding built up by their deceased spouse, and equally to ensure that the surviving business partner gains full control of the business and has no ongoing financial strain of having to pay the deceased's spouse a suitably arranged life insurance policy could be put in place whilst all parties are healthy enough to be insured.

How?
Firstly, businesses should establish what they might wish to happen if one of the owners dies. It is likely to be relatively simple in a two-person business but with more than two owners it may be more complex.

As part of the process above a firm needs to establish a fairly accurate valuation of the business. Generally this can be done by discussing this in detail with the Accountant or Financial Adviser.

Insurance Policies
There are several different types of life insurance policy that would be suitable for this type of arrangement and this will need to be discussed with your Financial Adviser.

Term of policy
The term of a life policy is usually an influencing factor when it comes to the premium cost. The longer the term, the more likely the individual is to die, and therefore the more costly the plan. It is however very dangerous in this situation to take a short term life both for the issues of future potential insurability of the life assured as well as the costs involved in setting up the plans.

In terms of the setting up costs, as well as the premium and the Financial Adviser fees (which may be paid out of commission but may also require a not insignificant top-up fee), is the cost of a company's personal time in having to decide on what to do, to complete the application forms and other associated documents and then potentially to include medical evidence or examinations.

We would therefore never usually recommend terms of less than 10 years and in most cases would suggest considering Whole of Life insurance to be used.

Setting up the Plans
There are also different ways of actually setting up the life policies. The most common would be:

1. The policies could be taken out by each person at the required level and then placed in trust (usually a flexible trust) in favour of the other shareholding partners. This means that the each individual will pay the premiums to their own life insurance policy. The premiums for the policy do not qualify for tax relief.
2. The policies could be taken out by the business on the lives of each shareholding partner. The company could then pay the premiums but it is inadvisable to attempt to claim tax relief on the policy premiums to the plans.

Tax considerations
Generally the most beneficial option is 1 above although in our experience firms would generally prefer option 2. Option 1 ensures that the arrangement remains as tax efficient as possible at the point of the claim. If option 2 is adopted, although tax relief can be granted on the premiums, the lump sum benefit may be taxable in the hands of the company thereby necessitating an even higher sum insured on the life policy.

It is also essential that the policies are written in trust as otherwise Inheritance Tax may become an issue if the policy pays out.

Cross Option Agreement
Assuming the life policies are in place and written in trust, when a shareholding partner dies, the policy sum assured will be paid under trust to the surviving partner(s). They could simply fold the business at that stage and walk away from it giving none of the value of the business to the deceased's spouse.

To prevent against this eventuality, the final stage of the process is to get each shareholding partner to complete a Cross Option agreement which states that if one party to the agreement wishes to sell or buy under the agreement, the other parties must concur. There are other options available but this is generally recognised as the most suitable solution as it provides the greatest flexibility and the least problems with tax.

Reviews
Finally, once established, the policies and arrangements need to be reviewed on a regular basis to ensure that the insurance value is appropriate to the estimated value of the business. An ongoing relationship with a Financial Adviser will help in this process to ensure products remain appropriate.

If you have any questions or need an independent review of your protection requirements as a business or individual, please contact us to discuss your situation further. AW Financial Management LLP is an Independent Financial Adviser regulated by the Financial Conduct Authority.

Information given in this document should not be taken as advice as it is intended for guidance only. If you wish to have an assessment of your own situation, you should contact the office for advice.