

Your guide to Share Protection



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Introduction

The purpose of this guide is to explain how our share protection scheme operates for companies, partnerships and limited liability partnerships (LLP).

This guide aims to answer the most common questions that you may be faced with whilst dealing with this topic. This guide refers to shareholding directors in a private limited company, partners in a partnership and members of an LLP. For the purpose of this guide they will be referred to as owners.

This guide describes our suggested method of setting up share protection utilising life or life and critical illness policies placed in **trust from outset**, plus a written agreement between the owners. The rest of this document assumes the policy will be placed in trust from outset and that all of the owners participate in the arrangement.

The documents we've referred to in this guide are for specimen purposes only and professional advice should be sought. **If the policy is not placed in trust at outset, you should seek your own legal and tax advice as our trust document cannot be used in these circumstances.** All examples used in this guide are based on using our trust forms. Clients should seek their own advice as to how their agreements and trust forms are drawn up and what documentation is required.

We accept no responsibility for ensuring that the trust and cross option agreement meets the owners' requirements.

Your guide to Share Protection

What is the aim of the agreement?

A share protection arrangement enables the surviving owners to purchase the deceased owner's share of the business from the deceased owner's estate and ensures that the deceased owner's dependants have a willing buyer and cash instead of a share of the business.

Critical Illness Cover can also be added when taking out cover at an extra cost, the agreement gives the owner the option to sell their share of the business if they are diagnosed with one of the specified critical illnesses we cover.

How does it work?

In order for the agreement to be implemented each owner must effect and maintain a life or life and critical illness policy which is written in **trust from outset** for the other owners. An agreement, typically a cross option agreement, provides the basis for the share purchase and details how the purchase can be made.

The agreement should be entered into, with one agreement covering all the owners. The completed trust document will be returned by us to the trustees and should be kept with the policy(ies).

Why is an agreement needed?

On the death of any owner, the Articles of Association, Partnership or LLP agreement should stipulate what happens to their share of the business. Usually their personal representatives and subsequently their beneficiaries will become entitled to their share of the business. The beneficiaries may find ownership of the share of the business provides very little benefit, especially where this is relatively small.

An agreement ensures that upon the death of one of the owners, the surviving owners can avoid that share of the business being owned by someone with no interest in the business, or even by another business that might then be in a position to make a takeover bid.

Most surviving owners in this situation will want to buy the deceased owner's share of the business and keep control of the business, but only a few will have the right amount of cash available at the right time. Some businesses may turn to their bankers, but many have existing loans that would rule out further advances. Also a crisis, such as the death of an owner, tends to create uncertainty and instability within a business, so banks will be less likely to be willing to make a loan. A critical illness could have a similar impact.

Sales of a share of the business to outsiders may be restricted and a sale to the continuing owners may only be possible if funding has been arranged in advance. This could mean that the family of the deceased owner may not receive the best price for their share of the business or possibly not find a buyer at all. The share protection agreement ensures that the beneficiaries can sell to a willing buyer and the remaining owners have both the right and the money to make the purchase.

How the agreement operates

The agreement is able to include options on death/terminal illness and, if selected, critical illness. The owners should indicate in the agreement which events they wish to plan for, which should also be reflected in the type of policies that are being arranged. The agreement operates as follows:

Death

On the death of an owner, their personal representatives have the option to sell their share of the business to the surviving owners. Equally, the surviving owners have the option to buy the deceased owner's share of the business from the personal representatives. If an option is exercised by either party then the other party would be bound to buy or sell, as the case may be.

The owners can exercise their option to buy the share of the business at any time within three months of the date of death.

The personal representatives can exercise their option to sell the share of the business at any time within six months of the date of death.

Terminal Illness Cover

An owner suffering from a diagnosed terminal illness (life expectancy less than 12 months) that results in a valid claim, will have the option to sell their share of the business to the other owners.

This option is available for six months after the date of receipt of the proceeds.

Please note: There is NOT an option for the other owners to buy the share of the business from the terminally ill owner. A single option agreement leaves the terminally ill owner in control, with the option to sell but with no corresponding option to buy given to his/her co-owners. On payment of a valid terminal illness claim no further benefits will be payable and the policy will end.

Critical Illness Cover

An owner suffering from one of the specified critical illnesses or disabilities that results in a valid claim under a life and critical illness policy, will have the option to sell their share of the business to the other owners.

This option is available for six months after the date of receipt of the proceeds under the life and critical illness policy, and not from the date that the critical illness is diagnosed.

Please note: There is NOT an option for the other owners to buy the share of the business from the critically ill owner. Although this option could be attractive to the other owners, it may not be for the owner who has had a heart attack and who intends to resume work, once fully recovered, after only a few months. A single option agreement leaves the critically ill owner in control, with the option to sell but with no corresponding option to buy given to his/her co-owners. On payment of a valid critical illness claim no further benefits will be payable and the policy will end.

Under their agreement, each owner must effect and maintain a life or life and critical illness policy under an appropriate trust, to provide the required amount of money to purchase the share of the business. The beneficiaries of the trust would be the co-owners of the business. This ensures that the proceeds from a policy are available for them to buy the owner's share of the business on death or diagnosis of a critical illness or terminal illness.



For further information on terminal illness please refer to your policy booklet.

For the critical illnesses we cover, please ask for a copy of our Guide to Critical Illness Cover.

Why is the agreement not a binding contract for sale?

Under current legislation the share of the business may qualify for 100% Business Property Relief for Inheritance Tax purposes. However, if the share protection agreement includes a binding contract for sale, such as a buy and sell agreement, any applicable Business Property Relief may be lost.

A cross option agreement gives the surviving owners an option to buy the owner's share of the business and the personal representatives of the deceased have a matching option to sell to the surviving owners, but neither is obliged until the other uses their option. This is not a binding contract for sale and therefore preserves Business Property Relief for the beneficiaries.

What price is to be paid for the share of the business?

It is important that when putting a cross option agreement in place, an appropriate method is agreed on as how the share of the business is to be valued.

Open market value of the business

This option would ensure that all parties are fairly treated. This can, however, lead to certain practical problems, such as how the business can be sure that the amount of cover in force equates to the value that would have to be paid? The reference to open-market value means that this has to be formally arrived at. This could lead to delays in the completion of the sale and purchase and often can result in the whole plan being delayed or even never finalised.

Fixed value for the share of the business

By adopting a fixed price method of valuation, the business adopts a method of valuing a share in a business. This method ensures that the appropriate level of life cover can be effected.

Legal & General's cross option agreement has been drafted on the basis that should death/a terminal illness (or payment under a life and critical illness policy) occur within three years of the agreement being established, a specified value (as written into the agreement) will be the price to pay for the share of the business. However, if death/a terminal illness (or payment under a life and critical illness policy) occurs more than three years after the date of the agreement a '**fair value**' will be paid.

Fair value of the share of the business

The fair value of the share of each owner will be the relevant proportion of the market value of the business as at the date of the owner's death or the Payment Date (as the case may be). This amount will be determined by an independent auditor or professional valuer who will be appointed by the surviving owners and the personal representatives of the deceased owner. If such a valuation is not carried out then the 'fair value' of the share of the business shall be the relevant proportion of the said market value as determined by the President for the time being of the Institute of Chartered Accountants in England and Wales.

Such an arrangement should be reviewed at least every three years to ensure it continues to meet the business's requirements. The amount of cover under the life or life and critical illness policy should also be reviewed at the same time. If this is not done the price to be paid under the agreement reverts to the 'fair value'.

Whilst Legal & General provide a cross option agreement, it is important that the owners get their agreement approved by their own legal advisers.

What if new owners join the business?

All new owners should enter into the arrangement by completing a supplemental agreement. An additional life or life and critical illness policy must also be effected and the appropriate trust deeds completed.

How long does the agreement last for?

The agreement can last indefinitely but, as mentioned earlier, regular reviews should be carried out.

What are the main taxation effects of the arrangement?

Inheritance Tax

Providing all owners participate, there should be no Inheritance Tax on the premiums payable as it will be considered to be a bona fide commercial arrangement.

Whilst a policy written in trust will not form part of the owner's estate for Inheritance Tax purposes, there are some occasions where there is a potential for an Inheritance Tax charge to apply to the trust itself. For example, on each 10-year anniversary of the trust (periodic charge) and when payments are made out of the trust (exit charge).

In most cases, if a Life Insurance policy with no surrender value is the only asset placed in trust, then provided that the life insured is in good health, the value of the policy for Inheritance Tax is likely to be negligible. The maximum charge of 6% of the value of the trust fund in excess of the nil rate band, will therefore also be negligible and there will be no Inheritance Tax charges payable during the policy term or at death.

Capital Gains Tax

There should be no Capital Gains Tax on the transfer of the shares on death, but there could be a liability on the beneficiaries of the estate if the value of the shares of the business increases between death and sale. However, this is rare.

A Capital Gains Tax liability may arise, in the event of the sale of an owner's share of the business due to a terminal or critical illness.

Income Tax

An Income Tax liability may arise from the potential reversion of the trust fund to the owner if they should resign or retire from the business or otherwise cease to be an owner. This is also known as Pre-Owned Asset Tax (POAT). However, given that the value of the life policy is likely to be negligible, the effect of this tax is also likely to be negligible.

There may be other taxation implications but this will depend on your individual circumstances. We strongly recommend that you consult your own legal or tax adviser before proceeding.

How are the funds to make the purchase provided?

A Life or Life with Critical Illness policy is written on the owner's life and then put in **trust from outset** for the other owners. In the event of a death or critical/terminal illness claim, the proceeds of the policy would be paid to the continuing owners. The cross option agreement requires that each owner shall, no later than one month after the date of the agreement, effect either a Life policy or Life with Critical Illness policy and write the policy in trust for other owners.

Who should pay the premiums?

Each owner undertakes to pay premiums on their own life. These may not necessarily be the same because of the different ages and amounts of cover. If possible, the business should adjust their pay or drawings to compensate for this.

If a company pays the premium on behalf of a shareholding director this will be classed as remuneration and the shareholding director will become liable for income tax and National Insurance Contributions (if applicable) on it.

What type of policy should be effected?

This will depend upon individual circumstances and affordability. For example, if it is not known when an owner will retire, a Whole of Life Protection Plan may be an appropriate policy.

If Critical Illness Cover is required this can usually be arranged as an additional option to a Life Insurance policy.

What if an owner leaves the business?

If an owner leaves the business the agreement will normally cease to apply to that owner.

The policy will automatically revert to the owner.

What if the amount of cover doesn't match the price to be paid for the share of the business as specified in the agreement?

If the agreement is reviewed and updated regularly, it's unlikely that the proceeds of the life policies will differ significantly from the price to be paid for the share of the business. However, if it isn't reviewed and amended, then the price to be paid under the agreement could differ significantly and may require a valuation based on what the business would be worth on the open market. This is the traditional method of valuing a business, and this could mean that the amount of cover under the policies may not match the price to be paid.

If the amount of cover is less than the agreed value, the agreement gives the option for the balance to be paid to the owner's personal representatives in instalments over an agreed period. The agreement allows specific details to be inserted regarding the number and frequency of payments. This amount may or may not bear interest and the appropriate wording should be deleted.

If however, the amount of cover exceeds the agreed value, the co-owners can, if they wish, pass the excess to the owner's personal representatives or keep it themselves. The agreement caters for either arrangement and if this form is used then the appropriate wording should be inserted.

What if the owners don't wish to specify a value for the share of the business to be purchased?

The owners should be encouraged to specify a value. If they don't, then an amendment to the agreement will be needed in order to revert to the ordinary open market value at the time the purchase is made.

Will the agreement prevent an owner from selling any of their share of the business during their lifetime?

The Articles of Association, Partnership or LLP agreement should govern this but the provisions detailed in the sample agreement will not prevent any sale or other disposal of the owner's share of the business during his lifetime. The agreement only covers share transfer on death, terminal or critical illness (if selected) of the owner.

What if there's already a share purchase agreement in force?

It is important that this is reviewed. We provide an agreement for the consideration of the client's legal advisers, should they wish to change it. The company's legal advisers should ensure there is no conflict between any existing agreement and the wording of the cross option agreement.

Other Share Protection arrangements

The buy and sell agreement

The owners enter into an agreement whereby on retirement or death, the retiring owner or their estate sell their share to the remaining owners who, in turn, must buy. The owners will purchase the share of the business in the proportion in which the remaining ownership is held. There may be disadvantages in using the buy and sell method such as the loss of Business Property Relief, so if an owner dies, their share of the business may be liable to Inheritance Tax.

Company buyback

The shareholding directors enter into an agreement whereby the company buys the shares on the retirement or death of the shareholder. The company then cancels the shares. The authorised share capital is reduced accordingly by the nominal value of the shares cancelled. There are a number of legal requirements for the buyback to take place and this can be a lengthy and relatively complicated process.

The automatic accrual method

Used mainly by partnerships in the event of death, the partner's or member's share is automatically acquired by the surviving members or partners in accordance with an agreement between them. A life policy may be used as part of such an agreement in order to compensate the deceased's family.

Trust information

Why use a trust?

A trust is a simple way of transferring the policy to the other business owners (the beneficiaries) without giving them full access to and control over it. The trust will specify who looks after and controls the asset (the trustees).

How is a trust set up?

Each owner must complete a trust at outset. The trust must be before the policy starts.

Who are the beneficiaries?

The beneficiaries are the other owners of the business.

What is a trustee?

A trustee is someone the owner appoints to look after the policy which is being put in trust. The trustees are the legal owners of the policy. They must keep to the conditions of the trust, and act for the benefit of the beneficiaries of the trust. They are responsible for making any claim on the policy.

Who should the trustees be?

Normally the other owners would be appointed as trustees. The owner who is the life insured will automatically be a trustee. It is also a good idea for them to be resident in the United Kingdom. Solicitors and accountants can act as trustees but they will charge for their services.

How many trustees should there be?

It is a good idea to have at least two trustees at any time. For this reason, it is normally sensible to appoint at least two trustees in addition to the owner.

What happens if a trustee dies?

If a trustee dies, the remaining trustees can still carry on but a replacement could be appointed. If the trustee was the last surviving trustee, their legal personal representatives will have the power to appoint additional trustees or take over as trustees themselves.

What happens if a trustee no longer wants to be a trustee?


A trustee can retire from the trust with the consent of the other trustees, provided that there are at least two trustees following the retirement.


How do the trustees make a claim?

In the event of the owner's death the trustees will need to send the following items to Legal & General's Customer Claims Department:


- Share Protection trust (and any subsequent deeds)
- The original policy documents
- A death certificate

The address to send these items to is:

 Legal & General Customer Claims Department
City Park
The Droveaway
Hove, East Sussex BN3 7PY

 Telephone **0800 137 101**

Once the claim is accepted, the trustees will be paid by direct credit.

 For other claims, please call us on freephone (from landline):

For terminal illness claims **0800 137 101**
For critical illness claims **0800 068 0789**

We may record and monitor calls.

Important notes

We have written this guide to give general information about placing business protection policies in **trust at outset** for **business owners**. It is not intended to replace legal advice. If this trust does not meet the owners' needs then they should talk to their legal and their financial advisers.

We have based the information in this guide on our understanding of the laws relating to trusts and tax at the time of this publication. Although we have made every effort to make sure that the information is accurate, we cannot take legal responsibility for any particular statements.

This guide is based on our understanding of current law and HMRC practice, which can change.

In preparing this guide we have assumed that only Legal & General's Share Protection trust is to be used in conjunction with Legal & General's business protection policies. The information in this guide does not apply to family protection.

Legal & General have separate literature for family protection. Please see your financial adviser for more details.

Alternative formats

If you would like a copy of this in large print, braille, PDF or in an audio format, call us on **0370 010 4080**. We may record and monitor calls. Call charges will vary.

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