

# ownership protection

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## 2

### The loss of a partner, member or shareholding director can have a major impact on the success of a business in terms of ensuring continued control for the remaining owners.

However, we also need to think of the effect on the dependants of a deceased owner, or the position of a critically ill owner who might wish to leave the business.

The potential problems that might arise can depend on the business type, the size of the business share, and the procedures laid down in the articles of association or the membership or partnership agreement if there is one.

For example, if one of the owners of a limited company becomes critically ill or dies:

- They or their family might want to sell their share of the business. This could be to a competitor or some other unsuitable buyer. If the owner was a majority shareholder then control of the business has been lost.
- If the outgoing owner had at least 75% of the shares then they could also force the outright sale or winding up of the business.
- Perhaps the owner's family may wish to become involved in the business, which may be at best disruptive or at worst unacceptable to the other owners. A majority shareholding allows the new owner to appoint themselves as a director and remove other directors, gaining day-to-day control of the business.
- The other owners may have to use funds they intended for other purposes to buy the share of the deceased or ill owner.

In a partnership the existence of a partnership agreement will be important:

- If there is no agreement then the Partnership Act 1890 will dictate what happens. If a partner dies then the partnership has to be wound up and their estate will usually require the partnership share to be paid out.

The existence of a membership agreement will also be important for a LLP:

- If there is no agreement the Limited Liability Partnership Act 2000 will dictate what happens. If a member dies and their membership interest passes to someone else, the other person may not interfere with the management of the business, but they will be entitled to receive anything that would have been due to the member.

If there is an agreement:

- Then it should dictate how the share is to be paid out to the estate or a retiring partner or member. Typically this might mean payment over a 5-year period.

In any of these situations the need to find a large cash sum would come at a time when the business is also suffering the financial impact of losing a key partner or member.

So it is important that, if this happens, plans are in place for the remaining owners to be able to buy a critically ill or deceased colleague's share of the business.

The aim in setting up this cover is to ensure:

- The remaining business owners retain continued control of their business
- The estate of the deceased owner, or the outgoing critically ill owner, gets fair value for selling their share of the business
- The arrangement is set up in a tax-efficient manner

There are several ways this can be done, depending on the type of business, which are explained over the page.

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## individual purchase – companies, LLPs and partnerships

The first solution is for each owner to take out a protection plan on their own life for the value of their share of the business. This plan is written under the Bright Grey business trust for their co-owners. All owners enter into an appropriate agreement. If one of the owners suffers a critical illness or dies, the others would receive the funds to purchase the ill or deceased owner's share from the owner or his personal representatives.

The deceased's personal representatives would distribute the proceeds in accordance with the deceased's will or the rules of intestacy.

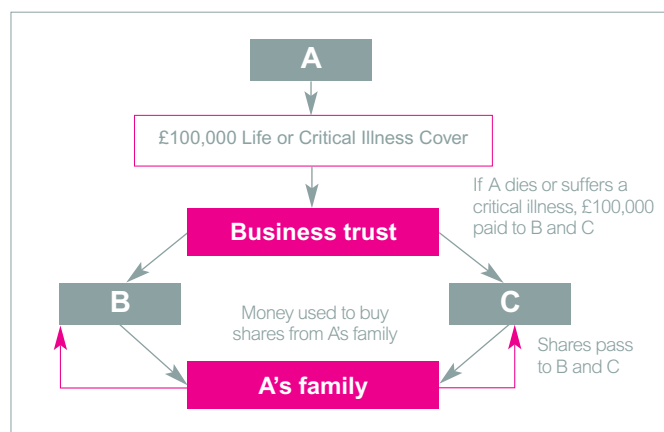
Alternatively, if there are only 2 or 3 owners it is possible for each owner to take out a life-of-another plan on the lives of each of the other owners. If one of the owners dies or suffers a critical illness, the plan would pay out directly to the other owner. They would therefore have the money available to buy the ill or deceased owner's share of the business.

Using the Bright Grey Business Protection Menu you can have separate amounts of cover for 2 different people in the same plan. For up to 3 owners they could therefore take out cover using this method with only one quote, one application and one plan charge for each owner. However, this route would not be appropriate if there are more than 3 owners or it is likely the ownership will change in the future. In these circumstances own life policies written under the Bright Grey business trust should be used.

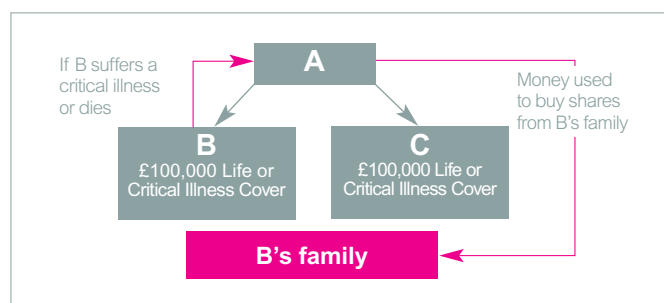
### The trust

The Bright Grey business trust has been designed specifically for use with business protection plans. The trust is a fully discretionary trust giving the flexibility to automatically add any new partner, member or shareholder who joins the business and remove any partner, member or shareholder who leaves.

The plan **MUST be written in trust from inception**. Please see the taxation section on page 22 for a full explanation.



OR



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## The cross option agreement

An appropriate agreement is needed between the shareholders for the disposal of shares on death or critical illness. It must not be a binding agreement for sale otherwise business property relief from inheritance tax will not be available. There is further information on business property relief in the taxation section.

The business's legal adviser should draw up the cross option agreement to make sure it does not conflict with the articles of association or an existing partnership or membership agreement. The agreement works by creating a 'sell' option for each owner in the event of their death and/or critical illness and a 'buy' option for the co-owners in the event of death only. The exercise of the sell option will mean the surviving owners must buy the dead or critically ill owner's share; the buy option will require the deceased owner's personal representatives to sell the deceased's share to the surviving co-owners.

If the arrangement is to include options on critical illness your clients need to consider whether they only want an owner who suffers a critical illness to have a single option allowing them to sell, or if they also want the other owners to have an option to buy.

If they choose a single option on critical illness, the owner who suffers a critical illness cannot be forced out of the business against their will. This gives that owner the opportunity to continue in the business if they recover and are able to return to work. But it also means that if they are unable to return, the remaining owners have no right to buy their share of the business. This could mean that the ill person is still entitled to their share of any profit even though they are no longer contributing to the business.

Alternatively, your client could choose to include a double option in the event of a critical illness. However, this would operate differently to the cross option on death. In the event of an owner suffering a critical illness, they have an immediate option to sell. If they exercise that option the other owners must buy that share of the business. But the other owners would not be able to force the ill owner out immediately. Instead they would have an option to buy only if the ill owner does not return to their normal duties within a specified period, usually 12 months. This gives the ill owner the opportunity to return to the business if they are able, and the other owners the security of being able to remove an owner who is no longer able to contribute.

A specimen cross option agreement for consideration by the business' legal advisers and a specially designed business trust along with a comprehensive guide on how to complete the form, are available from the literature section of our website [www.brightadviser.co.uk](http://www.brightadviser.co.uk) or can be ordered at [www.brightadviser.co.uk/literature](http://www.brightadviser.co.uk/literature)

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## company purchase – companies only

The second solution is for the company to purchase the shares of the deceased or ill shareholder. The result of the share buyback is that the shares purchased are cancelled and revert to unissued share capital. The actual number of shares of the remaining shareholders remains the same, but the proportion of the issued share capital that each shareholding represents increases.

Company share purchase must be permitted by the articles of association, and is subject to a number of conditions. The most important of these are outlined below. You should refer to the Companies Act 2006 Part 18 for full details.

The general rule is that any purchase of a company's own shares must be made out of the distributable profits of the company or out of the proceeds of a fresh issue of shares made for the purpose of the purchase.

Subject to stringent requirements a repurchase of shares out of capital reserves may be allowed. Such a capital payment may only be made after all distributable profits have been exhausted and is made by reference to 'relevant accounts'. The directors must also make a statement and the auditors will be required to report to the directors whether they feel a purchase out of capital is acceptable given the financial position of the company.

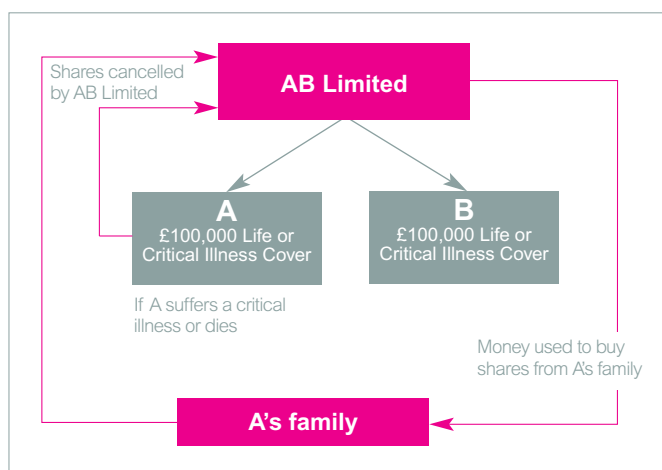
The company and each shareholder individually enter into an appropriate agreement that would provide for the purchase of the shareholder's shares on death or critical illness. At the same time the company takes out Life or Critical Illness Cover on the shareholder, the sum assured of which would pay for the share purchase.

### The cross option agreement

An appropriate agreement is required between the shareholder and the company for the disposal of shares on death or critical illness of the shareholder. Separate cross option agreements may be required for each shareholder.

The company's legal adviser draws up a cross option agreement. The agreement works by creating a 'sell' option for the shareholder in the event of their death and/or critical illness and a 'buy' option for the company in the event of death only. The exercise of the sell option will require the company to buy the dead or critically ill shareholder's shares. The buy option will require the deceased shareholder's personal representatives to sell the deceased's shareholding to the company.

This is subject to meeting the relevant company law requirements. This may mean that even with the agreement and protection plans in place the purchase and sale of the shares cannot take place. A specimen cross option agreement for consideration by the company's legal advisers is available from the literature section of our website [www.brightadviser.co.uk](http://www.brightadviser.co.uk) or can be ordered at [www.brightadviser.co.uk/literature](http://www.brightadviser.co.uk/literature)



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## automatic accrual – partnerships and limited liability partnerships only

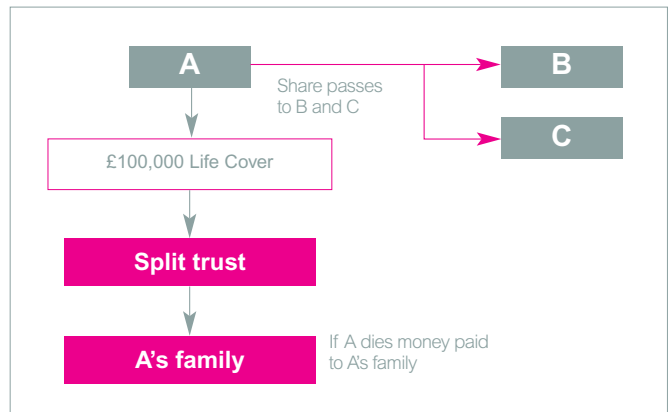
This arrangement would usually provide that on the death of a partner or member their interest (or more commonly the value of the goodwill) would pass automatically to the remaining partners or members. The deceased’s family receives no payment for that interest or goodwill. The family is compensated for the loss of this interest by a protection plan set up by the partner or member on their own life.

An automatic accrual agreement should include an undertaking by each partner or member to maintain a protection plan on their own life to the value of their share.

The protection plan should be written under the Bright Grey split trust for the partner’s or member’s family. This will avoid the cover falling within their estate for inheritance tax and the delays that accompany the probate process.

Automatic accrual arrangements may also cover retirement. This will need to be taken into account in planning for future financial security.

Automatic accrual agreements are commonly found in professional practices, where goodwill forms a significant part of the value. However, it is important to note that these agreements usually ignore the value of the partner’s or member’s, capital account and any loan accounts that are outstanding. These can sometimes be substantial and it will often be necessary to consider appropriate protection plans for co-partners or co-members to provide the necessary funds that are needed to repay any partnership or membership loan account that is still outstanding on a partner’s or member’s death.



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## equalisation of premiums

Where each of the shareholders, members or partners has set up trust plans for share purchase, it is possible to make an equitable arrangement to even out any differences between the premiums that each is paying.

The partners, members or shareholders may agree to equalise costs according to the potential benefit each may receive. Equalisation removes the inequality of an older or more significant shareholder, member or partner paying more for cover than younger or more minor shareholders, members or partners, while gaining less benefit.

Equalisation brings about a fair distribution of costs. In addition, where there are significant differences in the costs and benefits there is a danger that HM Revenue and Customs might view this inequality as conveying a 'gift' from one partner or member to another. If so, the arrangement may not be considered commercial and the premiums and policy proceeds would go back into the estate for inheritance tax purposes. This danger is particularly acute in family companies, especially in generational arrangements such as parent and child where HM Revenue and Customs will be more likely to assume there is an intention to gift.

### For example:

#### ABC Ltd. share capital £200,000

| Shareholder | Age | Share | Value +£ | Premium |
|-------------|-----|-------|----------|---------|
| A           | 51  | 40%   | £80,000  | £740    |
| B           | 41  | 30%   | £60,000  | £210    |
| C           | 31  | 30%   | £60,000  | £200    |

If A dies, B and C will be entitled to purchase his share of the company between them on a proportionate basis. The portion each can buy is:

own holding

joint holding of remaining shareholders

As they hold 30% each they are entitled to purchase one half each ( $30/(30+30)$ ) of A's shares. Therefore A's premium should be paid 30/60ths by B and 30/60ths by C.

If B dies, a similar situation arises except that A owns 40% and C owns 30%, therefore A will be entitled to purchase 40/70ths of B's shares and C 30/70ths.

If C dies, A will be entitled to 40/70ths and B 30/70ths.

It is therefore equitable if the share of the total premiums actually paid is related to the potential benefits each receives.

**In A's case:**  $(40/70 \times 210) + (40/70 \times 200) = \text{£}234.29$

**In B's case:**  $(30/60 \times 740) + (30/70 \times 200) = \text{£}455.71$

**In C's case:**  $(30/60 \times 740) + (30/70 \times 210) = \text{£}460.00$

To help you provide these figures for your clients we have developed an equalisation calculator. You can find this on our website at [www.brightadviser.co.uk](http://www.brightadviser.co.uk)

#### In summary:

Theoretically each shareholder is responsible for paying his or her own premium. They then arrange to equalise the costs by working out the difference between what they are actually paying and what they should be paying:

**B to pay A**  $\text{£}455.71 - \text{£}210.00 = \text{£}245.71$  a year and

**C to pay A**  $\text{£}460.00 - \text{£}200.00 = \text{£}260.00$  a year

**Note:** The above premium figures are for illustration purposes only. Full details and individual quotations are available on request.

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## calculating the value

Valuing a business is a difficult task. The sensible course of action is to involve the business's other professional advisers, their solicitor and accountant, to find the most appropriate valuation method.

### Companies

In valuing a company always refer to the company's articles of association to see what, if any, restrictions there are on the transfer of shares and if there is a valuation clause included. The number of conditions relating to the transfer of the shares will affect their value. Many articles simply allow the directors the discretion to refuse to register the transfer to any person for any reason. Larger companies may have more complicated restrictions. The valuation methods could range from allowing the company's auditors or an expert valuer to fix the price or putting a fixed price on any transfer, for example £1 per share.

There are however 3 commonly used methods. These are:

#### 1. Dividend yield

By applying the level of yield a buyer might require from their investment to the actual dividend produced we could find the capitalised value or the price per share they might be willing to pay.

#### 2. Capitalised earnings

In this method a price/earnings (p/e) ratio is used to capitalise a company's earnings after the deduction of corporation tax to determine the value of shares.

#### 3. Net assets

Net assets shown on a company's balance sheet are not necessarily a helpful guide to the valuation of shares as they will usually be valued on the 'historic cost' of their purchase, and then down-valued each year in line with the depreciation method adopted by the accountants. This could result in a property with a market value of say £1 million being valued in the books at a less than £200,000 if it was purchased some time ago.

However, whichever method is used in producing a valuation it is essential to keep in mind the net asset position. It is also necessary, where possible, to replace the written down asset values shown in the balance sheet for their open market value.

### Partnerships and LLPs

Partnerships and LLPs are particularly difficult types of businesses to value as much of a partnership's or LLP's value is often in the form of goodwill.

Commonly used methods include:

#### Average partnership or membership profits

The value of the partnership or LLP can be expressed as a multiple of the average of the last given number of years' profits.

#### Value goodwill

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

#### Net assets

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

#### Sole trader

A sole trader has 2 choices: to sell their business as a going concern, in which case there will be a market value, or to wind up their business realising the value of assets less debts. As a sole trader's protection will be set up on an individual basis, an exact valuation is not vital. But the cover needs to be enough to provide for their family and pay all the business debts.