

Business protection ●●●

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Selling business protection



Protection. We make it personal.

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Business opportunities

Running your own business can be all-consuming, leaving little time for much of anything else. So it's no surprise that many business owners haven't found the time to think about business protection and why they might need it.

This means that the opportunity for advisers in the business protection market is huge. But with apparently more technicalities than personal protection, it can seem a more daunting field to work in.

The good news is that it doesn't have to be difficult. Bright Grey offers a huge range of material to help you with the business sale. This guide is just a start. It offers an outline of all the things you might need to consider and the options available to you as an adviser. But we offer so much more.

We have a wide range of consumer-facing booklets from loan protection, relevant life policies to key person protection – there's something to suit the needs of most small to medium-sized enterprises. And our range of sales aids can also show you how to maximise every sale.

Why not have a look online at www.brightadviser.co.uk/business to see how we can help you develop and grow your business protection business?

A stylized, handwritten signature in white ink, consisting of several loops and a long horizontal stroke.

Kevin Stevens, Head of Sales
Bright Grey

Entering the market

Business protection is perceived as being complex by many intermediaries. But advisers can enter the market and create significant revenue in just a few simple steps.

The business protection industry is an untapped market. A recent report by the British Chamber of Commerce estimated there is a £1.1 trillion protection gap in the business sector.¹ That's a huge opportunity!

The same research showed that 98% of businesses had at least one key individual in their business (someone whose death or serious illness would impact on company profits). And just less than half expected their business to fold within a year. So it's a real surprise to find that more than 90% have no cover in place.²

As well as being unable to cope with the death of a key person, very few businesses will have the cash available to buy a shareholder's shares or a partner or member's interest if they die. Without this, the interest will automatically pass to the deceased's family and may cause disruption to the business. Others will be sole traders who need protection in order to keep the business afloat when they are ill.

Types of protection

Key person, shareholder, partnership, membership and sole trader protection are all forms of business protection that an adviser can recommend to ensure they are meeting their clients' needs. Jerry Bayman, national corporate sales manager at Bright Grey, warns that if advisers do not help their clients cover these risks it could raise treating customers fairly issues.

"You are running a risk if that key person or owner dies and the business suffers heavy losses or the estate has to offload shares at a discounted price," says Bayman, "the client may ask you why you didn't do your job properly. In an increasingly litigious world do you want to take that risk when you could be earning money by avoiding it?"

As well as meeting their clients' needs, advisers could create further revenue by advising on business protection. Bayman points out that case sizes are usually £500,000 and over and the age of potential clients is also higher in the 35-50 age bracket. This means that premiums and commissions can be greater than in the individual protection market.

Sales tip

Bear in mind multi-sales opportunities when advising a small business. It may have multiple directors who each need key person and shareholder protection. You may also be able to cross-sell across the client investment and pensions business.



“Advisers may also have professional introducers, such as accountants and solicitors, who they can tap into for business protection opportunities”
Jerry Bayman

Identifying clients

Making the initial foray into business protection might be daunting for advisers, but Bayman says it is not as hard as they might think. A lot of advisers will already have clients on their books who are directors, sole traders or business owners and who may therefore require protection.

Advisers may also have professional introducers, such as accountants and solicitors, who they can tap into for business protection opportunities.

“Accountants should be able to understand the financial consequences of losing a key person if they are close to the business and also be aware of the indebtedness of the firm with all the risks that carries,” says Bayman. “Solicitors will often be drawing up partnership agreements and articles of association, which deal with the business succession issues on death or long-term illness. As part of this, they should be ensuring that there is cash in place to fund this.”

Bayman recommends that advisers target small to medium-sized enterprise (SME) clients, as there is less chance they will have a succession strategy in place on the loss of a key person. In addition, there are a significant number of SME businesses in existence in the UK. According to the Department for Business Innovation and Skills there are over 1.2 million SME businesses who employ less than 249 employees and another 3 million sole traders.²

Extra help

Bright Grey understands that business protection can seem complex. That’s why we have a wealth of knowledge and support available to help make the business protection sale easier. As well as help from our technical support unit, you have access to highly experienced underwriters and a customer support team who are dedicated to all business protection cases. Not just the big ones.

We also have a range of online tools and literature to order which will help make your life even easier. From sales ideas to technical guides, there’s something there to help you, whatever your experience level.

What you need to know

- The policy set-ups that different business formats need
- How premiums and benefits are taxed
- Trusts and inheritance tax rules
- How business succession strategies work.

The size of the opportunity

- 4.8 million business enterprises were estimated to exist in the UK at the start of 2008.²
- 99.9% of these were classed as small or medium, having between 1 – 249 employees.²
- £1.1 trillion is the shortfall in the protection gap in the business sector.¹

Sources:

- 1 Research commissioned by the British Chamber of Commerce 2009.
- 2 Department for Business Innovation and Skills, October 2009.

Finding clients

Advisers who are already familiar with business protection can develop their business further through professional connections.

Professional introducers, such as accountants and solicitors, are ideally placed to spot the risks that businesses face if they lose key people and owners. Many have a close relationship with their clients and have a good understanding of the business's structure.

Establishing a close relationship with accountants and solicitors is therefore one of the most effective ways for advisers to increase the amount of business protection they are writing.

Jerry Bayman, national corporate sales manager at Bright Grey, says that if advisers do not already have professional connections, they can try contacting local accountants and solicitors in their area. Some issues to consider when deciding which accountants and solicitors to target include geographical location, size and speciality.

"There is not much point in going after larger accountancy practices if you have little corporate experience," says Bayman. "Conversely, if the corporate market is your preferred strength then smaller solicitor practices are probably a waste of time – you would be better going for larger commercial practices."

Another way is for advisers to develop relationships with their clients' own accountants and solicitors.

"If the adviser is drawing up a pension plan they can drop a note to the accountant and let them know what they are doing," says Bayman.

"Most professionals get very frustrated when clients seek advice elsewhere and never hear about it and therefore welcome this kind of information."

Accountants

Once a relationship has been established, Bayman says, advisers should try and get an accountant to incorporate business protection-related questions into their audit checklist. This could include finding out what existing cover is in place, whether there are any key employees whose death or serious illness could cause a loss of earnings, what loans the business has and whether the business has a funded exit strategy on the loss of a shareholder, member or partner.

Sales tip

You could also offer accountants a 'compliance audit' service to check whether their clients' existing business protection is effective.



“Professional introducers, such as accountants and solicitors, are ideally placed to spot the risks that businesses face if they lose key people and owners”

Solicitors

Solicitors are a good source of contact because they will be involved in drawing up business documents, such as partnership agreements. These may have clauses that determine how the partnership share will be dealt with on death, for example requiring the share to be paid out in monthly instalments.

Solicitors may also be responsible for writing a business’s Memorandum and Articles of Association. The latter may include a ‘pre-emption’ clause, which ensures that on the death or retirement of a shareholder the remaining shareholders have the first option to buy the shares.

“While it is prudent to have these sort of arrangements in place to ensure a clean succession, it more often than not ignores the salient fact that there is not enough money to fund the transaction, especially at a time when the business has just lost a key player,” says Bayman. “So the IFA should work with the lawyer to make sure checklists are in place to ensure these agreements are backed up by hard cash.”

Cross-referral

Another way for advisers to build up their business protection book is to use contacts within their own firm.

Advisers within the same company may have different areas of specialism, but this doesn’t have to mean that their company can’t do business for all these areas. A client might currently be buying business protection but mentions that they are also considering renewing the insurance for their premises. This would be an ideal opportunity for the adviser to pass them onto the firm’s general insurance broker. Likewise, the general insurance broker could pass protection queries back.

Business accounts

Business protection opportunities can also be identified by looking at a client’s accounts. This includes:

- **The director’s report:** this will highlight who the key people are and if there are any changes in the shareholding over the year
- **The balance sheet:** this will show any loans that may need covering
- **The profit and loss account:** this can help identify key person contributions, such as a sales director who accounts for 20% of the company’s turnover
- **Company information and annual return:** these give more detail about the business and directors, in particular who the shareholders are.

Key person protection

The success of almost all small and medium sized businesses is dependent on a few people who make a significant contribution. Ensuring the business is covered in the event of their death or serious illness is therefore a fundamental step.

Key people can include owners, senior directors, sales people, production managers, research and development staff – the list is endless. Often the key person has specialist skills or knowledge and their value to the business is reflected in their remuneration package – although this may not always be the case.

Why do they need to be covered?

Whatever the key person's role, their loss could have disastrous consequences for the business. It could mean loss of profits, loss of contracts, difficulties meeting loan repayments or even having to repay a loan the key person has taken out for the business. It could also mean loss of knowledge of the business and its processes. And it could mean the loss of important business contacts and goodwill going forward. That's why businesses should be keen to have insurance in place for their key people.

What kind of cover is needed?

There's nothing mysterious about key person cover. At its most fundamental, it's simply a case of a business insuring its key people for life and/or critical illness cover, and making sure that if they die or suffer a critical illness, the business is compensated by the insurance money. This can give the business the necessary cash injection to make sure it survives.

Businesses can also consider taking out key person income protection to help cover the cost of sick pay or pay for a temporary replacement if a key person is ill and cannot work. And in certain instances it makes business sense for key individuals to take out personal income protection. Waiver of premium is another consideration.

Who are the key people?

- Owner/proprietor
- Managing director
- Sales director
- Finance director
- Product designer
- Production manager
- Specialist staff
- Technical staff



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How much cover is needed?

There are no hard and fast rules as to how much cover a business requires, but businesses tend to base their cover on one of the following criteria:

- Multiple of profits
- Multiple of salary
- Proportion of salary

Multiple of profits

As one of the main objectives of key person cover is to protect the profitability of the business, it can make sense to start with the profit. The following multiples are generally used:

2 x gross profit, or

5 x net profit

These would be the upper limits on the business as a whole, so where there is more than one key person, cover would need to be apportioned according to each key person's contribution.

Multiple of salary

A multiple of salary and benefits package is a useful guide to the cost of a replacement. Between 7 and 10 times gross salary can be considered. Caution needs to be taken when using this measure with shareholders, however, who may be taking a reduced salary which does not reflect their real value.

Proportion of salary

This method of calculating cover assesses the key person's contribution to turnover using the formula:

$$\frac{KPS \times T \times Y}{TS}$$

KPS =	Key person's salary
T =	Turnover
Y =	Years to recruit and train a replacement
TS =	Total salaries

It is also worth remembering that protection should not just be limited to business needs. Many business owners also have big financial commitments beyond the business to consider, such as their mortgage, utility bills and all the normal expenses of providing for a family. These still need to be paid, so protection from all angles needs to be considered.

And help is not always limited to a financial payout. Bright Grey includes practical help in their plans at no extra cost, which can benefit the individuals and the business too. This can range from medical, legal and career helplines, to the advice and support of a qualified nurse at the point of claim. It can also include support for the business in recruiting a temporary or permanent replacement for key individuals.

Ownership protection

The loss of a partner, member or shareholding director can have a major impact on a business. Without protection in place, a range of problems can occur.

Just like key person and loan protection, the approach taken to ownership protection very much depends on the business type, the deceased owner's share in the business and the articles of association, the partnership agreement or limited liability partnership agreement. All of these help determine the best structure for the protection plan set up to ease these problems.

Limited companies

If one of the owners of a limited company becomes critically ill or dies and the remaining owners do not have the funds and the option available to buy their shares, the following issues may arise:

- If they are a majority shareholder and they or their family want to sell their share, control of the business could be lost to someone the other owners are not happy about
- If the outgoing owner has 75% of the shares or more, they could force the outright sale of the business
- The owner's family may want to become involved in the business. This can often be disruptive or unacceptable to the other shareholders. A majority shareholding allows a new owner to appoint themselves as a director and to remove other directors. So they could gain day-to-day control of the business if plans are not in place to prevent this from happening.

Partnerships

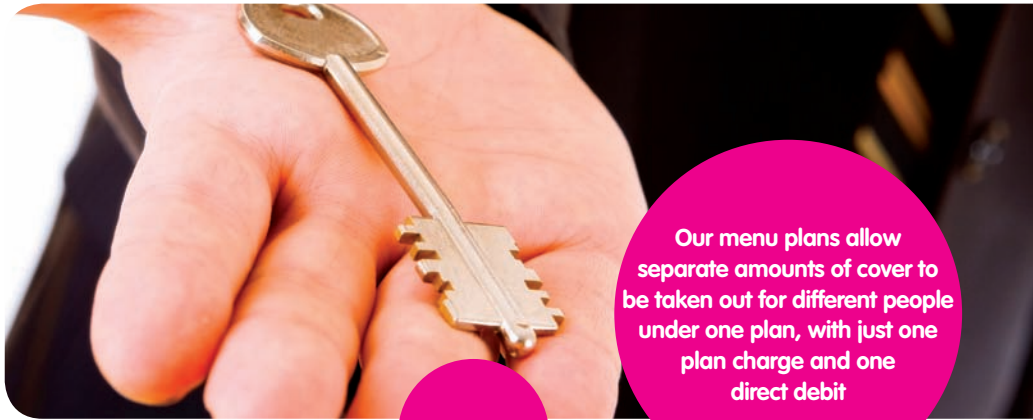
Partnerships share similar concerns and having a partnership agreement in place is very important. If there is no agreement, then the Partnership Act 1890 dictates what happens. It means that if a partner dies, the partnership has to be wound up and their share of the partnership will have to be paid back to their estate immediately.

If there is an agreement, then it should dictate how the share is to be paid to the estate (or perhaps to the retiring partner). Typically this might mean payment over a 5 year period.

In both of these situations, the need to find a large cash sum arises at a time when the business is suffering the financial impact of losing a key partner. It is therefore really important that the remaining owners have protection in place that will enable them to buy a critically ill or deceased owner out of the business.

Limited liability partnerships

The existence of a membership agreement will also be important for a limited liability partnership. In the absence of an 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.



Our menu plans allow separate amounts of cover to be taken out for different people under one plan, with just one plan charge and one direct debit

Individual purchase of the shares

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. These plans should be written under trust and set up so that the proceeds go to the co-owners.

Then, if all the owners also enter into an agreement that enables them to purchase the ill or deceased owner's share, they have the funds to do so.

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. Then, if one of the owners suffers a critical illness or dies, the plans would pay out directly to the other owners. Again, this would give them the funds to buy the critically ill or deceased owner's share of the business.

Menu plans often enable separate amounts of cover to be taken out for different people under the one plan.

The cross-option agreement

An appropriate agreement is required between the owners for the disposal of a share 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.

The business's legal adviser should draw up the cross-option agreement to make sure it does not conflict with the articles of association, an existing partnership agreement or limited liability partnership agreement.

The cross-option agreement works by creating a 'sell' option for each owner in the event of their death and/or a critical illness. Exercising this will mean that the remaining owners must buy the shares. A 'buy' option is also created for the co-owners in the event of death only. This will require the deceased owner's representatives to sell the deceased's shares to the other co-owners.

Limiting the buy option to death only means that an owner who falls critically ill is given 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 to work, the remaining owners have no right to buy their share of the business which can be a problem.

The double option

Alternatively, a business may choose to include a 'double' option in the event of a critical illness.

This gives the owner who suffers the critical illness the immediate option to sell. It also gives the other owners the option to buy after a deferred period of, say, twelve months if the owner remains critically ill and has not returned to the business. This means that the ill owner cannot be forced out right away, but the business has protected itself from what could become a long-term problem.

Ownership protection (continued)

Company purchase of the shares

A second solution is for the company to buy the shares of the deceased or ill shareholder – effectively a share buyback. While the actual number of shares the remaining owners have does not change, fewer shares remain so the proportion they own of the whole company increases.

Company share purchase must be permitted by the articles of association and is subject to a number of conditions outlined in the Companies Act 2006.

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.

However, subject to stringent requirements, a repurchase of shares out of capital reserves may be allowed. This can only be made after all distributable profits have been exhausted – the directors must make a statutory declaration and the auditors have to approve this approach. 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 a life and critical illness plan on the shareholder, the sum assured of which would pay for the share purchase.

As with the individual purchase of the shares, the purchase of the shares by the company also needs a cross-option agreement to be put in place.

The company's legal adviser should draw up this agreement and it 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.

Automatic accrual

This type of arrangement applies to partnerships only and usually ensures that if a partner dies, their interest in the business (or share of the value of the goodwill) would pass automatically to the remaining partners.

The deceased's family receives no payment. Instead, the family is compensated by a protection plan set up under trust by the partner on their own life. This will avoid inheritance tax and the delays that accompany probate.

Automatic accrual agreements may also cover retirement. They are commonly found in professional practices where goodwill forms a significant part of the value. However, these agreements usually ignore the value of the partner's capital account and any loan accounts that are outstanding. It is therefore often necessary to consider appropriate protection plans for co-partners to provide the funds needed to repay any partnership loan account on a partner's death.

Other considerations

Equalisation of premiums

Where shareholders, members or partners have set up trust plans to enable share purchase, it makes sense to make sure they pay an appropriate share of the premiums. This removes the inequality of an older or more significant shareholder, member or partner paying more than younger or more minor co-owners or partners while gaining less benefit.

They may, for example, agree to apportion costs based on the potential benefits they will receive.

If costs are not equalised, HM Revenue and Customs may view the inequality as conveying a 'gift' from one co-owner to another. If so, the arrangement may not be viewed as commercial, and premiums and policy proceeds would fall back into the estate for inheritance tax purposes. This is a very real danger in family companies.



To help you with the business protection sale, Bright Grey has developed an equalisation calculator. You can find this at www.brightadviser.co.uk/business

Calculating the value of a business

Valuing a business is far from simple, so it makes sense to involve other professional advisers, like the accountant or the solicitors, to find the most appropriate valuation method.

Companies

The 3 commonly used methods for valuing a company are:

- 1 Dividend yield:** by applying the level of yield a buyer might require from their investment to the actual dividend produced, the capitalised value of the price per share can be found.
- 2 Capitalised earnings:** a price/earnings ratio is used to capitalise the company's earnings after the deduction of corporation tax to determine the value of shares.
- 3 Net asset:** this is not necessarily the best guide to the valuation of shares as the net assets shown on the balance sheet are usually valued on a historic cost basis and their value decreases each year.

In valuing a company, always refer to the company's articles of association to see if any restrictions apply to the transfer of shares and if there is a valuation clause included. The amount of conditions relating to the transfer of the shares will affect their value.

And whichever valuation method is used, it is always worth keeping in mind the net asset position.

Partnerships

Much of a partnership's value is often in the form of goodwill, making them difficult to value.

Commonly used methods include:

- **Average partnership profits:** a multiple of the average of the last given number of years' profits
- **Value of goodwill:** the partners can take professional advice and agree on how they are going to value the goodwill
- **Net assets:** as with companies, this is not always the best measure of value.

Sole traders

A sole trader has 2 choices:

- 1 Sell the business as a going concern** (market value)
- 2 Wind the business up, realising its assets, less any debts.**

As a sole trader, protection is set up on an individual basis, so an exact valuation is not vital but the cover needs to be adequate to provide for dependants and pay off any business debts.

Loan protection

Many businesses take out loans and rely on a key person to repay them. Without protection, a business could suffer severe losses in the event of the key person's death.

Many businesses have to borrow funding to start up or expand. Often the ability to repay it lies with a few key people. Businesses need to make sure they have enough cover in place to pay an outstanding loan if something happens to those key people. The amount outstanding is generally apportioned between the relevant key people being insured.

Lenders usually need this cover, but many directors may have given personal guarantees and/or used their own residential home as security. So there is the added need to ensure that dependants are protected too.

Sometimes directors have made loans to their business, either by making a cash injection when needed, or leaving salary, bonus or dividends in the business. This is generally referred to as a director's loan account and it becomes repayable to the estate on the death of the director. Businesses therefore need to include this in the life cover sum they are insuring.

It makes sense to include the director's loan account when calculating the critical illness cover too, so that if the director suffers a critical illness, the company would be able to repay the loan and give the director much-needed personal financial security.

Also consider

- **Business start up:** when a business starts up it requires working capital. This can be at risk until profit flows have stabilised. So it is sensible to cover the key person's proportion of this risk
- **Management buy-out:** this will often be financed by a bank or venture capitalist, by a loan or by equity finance. Either way, the providers of the finance will be looking to protect their investment by covering the proportion each key person is liable for. As with any loans, there is also the question of any personal security that has been offered and the need to protect dependants.



A combined approach

The existence of menu plans means that different types of protection can be covered under one plan. This can be set up in a few simple steps.

Many businesses will need both key person and ownership protection, often for the same person. It makes sense to cover these needs under one plan.

For companies using life of another

The company can take out a protection plan on the life of each of the shareholders with enough cover to allow for the shares to be purchased and the key person to be covered. The company should also set up an appropriate agreement that would provide for the purchase of the deceased or critically ill shareholders' shares on their death or critical illness.

Part of the benefits can then be used to purchase the shares of the shareholder who has died or is suffering a critical illness. The company can hold onto the remaining funds for key person purposes.

For companies using own life in trust

Each of the shareholders takes out an own life plan under trust with enough cover to enable both the purchase of the shares and provide key person cover. The shareholders would be the beneficiaries and they should enter into an agreement that allows for the purchase of the shares of a shareholder who dies or suffers a critical illness.

If one of them does fall critically ill or dies, part of the benefits are used to purchase his or her shares. The remaining shareholders then loan the company the remaining funds for key person needs. This can be repaid tax free as a loan repayment once the company recovers.

For partnerships

Each partner can take out an own life plan with enough cover to pay for both the purchase of shares and provide key person cover. The plan is written under trust for the co-partners who should also enter into a cross-option agreement. If one of the partners dies or suffers a critical illness, the benefits are used to purchase their share from their family and the other partners can hold onto the balance for key person purposes.



Relevant life policies

A relevant life policy is an alternative way of providing a lump sum on death for an individual, without the need to set up a registered group life scheme.

They are governed by the same legislation that deals with group schemes. However unlike most large employer provided schemes they are 'non-registered', so do not fall under pensions legislation.

Group life schemes

Some companies are large enough to warrant running a registered group scheme that will pay for life cover in a highly tax-efficient way. Payments made by the company will not be treated as a PITD benefit, the company will usually be able to claim corporation tax relief on the payments and benefits are usually payable tax-free to the director's dependants.

However, until now, directors of smaller companies have missed out on this as it has not been possible to have a one-man scheme, and group risk providers are unlikely to cater for less than 5 members. These directors will be paying for personal plans from their post-tax income or from the company account. If it's from the company account then the payments would normally be treated as income in the hands of that director and taxed accordingly.

But following recent changes to group life legislation, Bright Grey has recognised there is a gap in the market and has introduced a way of writing life cover that benefits small companies.

Ordinary life policy

For the employee the payment made by the employer will be treated as the employer meeting a pecuniary liability of the employee – that's when the employee has entered a contract to make the payments but the employer pays them for the employee. The employee is therefore liable to both income tax and employee's national insurance contributions, so to provide the net payment this amount must be grossed up by the amount of tax and national insurance payable.

The employer will normally be able to treat the gross cost as a trading expense, whether paid as a salary, or if the payment has been made by the company.

The aim of the policy is to provide a lump sum benefit on the death of an employee up to £5,000,000. This removes the need for the company to set up a registered group life scheme.

Relevant life policy

Relevant life policies are primarily aimed at 2 groups. These are:

- High earning employees who have substantial pension funds and do not want their death-in-service benefits to form part of their lifetime allowance
- Small businesses that do not have enough eligible employees to warrant a group life scheme.

Bright Grey will also cover single directors for up to 15 times their remuneration (including dividends). This is equivalent to providing 4 times salary as death in service benefits and up to 11 times salary as a lump sum that could either be invested to provide an income or be used to buy annuity as an alternative to a widow's or dependant's pension.

The advantages

A relevant life policy can have a number of advantages providing it meets the criteria below:

- The benefit will not form part of the employee's lifetime pension allowance
- The premiums paid will not form part of the employee's annual allowance. The annual allowance is the amount that can be contributed by, or on behalf of, an individual to any registered pension scheme with the benefit of tax relief. The employee is therefore still able to make full use of their annual allowance to make contributions to a registered pension scheme
- Premiums paid by employers are not normally assessable on the employee as a benefit in kind and are therefore not subject to income tax
- Premiums paid by employers are not normally assessable for employer or employee national insurance contributions
- The premiums may be treated as an allowable expense for the employer in calculating their corporation tax liability, provided that the local Inspector of Taxes is satisfied they qualify under the 'wholly and exclusively' rules
- Provided the benefits are payable through a discretionary trust, in most cases the benefits are paid free of inheritance tax as the payment is not part of the employee's estate.

But the trust will be subject to normal inheritance tax rules for discretionary trusts, which in some circumstances may give rise to the following charges:

- Up to 6% of the value of the trust fund on each 10th anniversary of the date the trust was established (the periodic charge). A periodic charge will only apply if there is a value held in the trust at the 10th anniversary. This could happen, if for example, the employee dies shortly before the 10th anniversary and the benefits have not been distributed to the beneficiaries.
- Up to 6% of the value of the fund on appointment of benefits out of the trust to a beneficiary (the exit charge).

Qualifying rules

The policy must meet certain rules to qualify as a single person relevant life policy.

- **Before the age of 75:** The policy must only provide for a lump sum death benefit payable before the age of 75
- **Life Cover only:** No other benefit must be conferred under the policy
- **No surrender value:** The policy must not be capable of having a surrender value. There are circumstances in which a small surrender value is allowed, but under Bright Grey plans no such value will arise
- **Payable to an individual or charity only:** This can be payable through a trust and to maximise the tax efficiency of the policy it's recommended that the policy is issued under a discretionary trust from outset. Bright Grey can provide specimen wording
- **Genuine cover:** The main purpose of the policy must not be tax avoidance.

You can find the detailed legislation that defines these rules in the Bright Grey guide 'The benefits of relevant life policies'.

Setting up cover

The way cover is set up depends on the type of business that has been formed. Whether it's a limited company, a partnership, limited liability partnership or a sole trader, each will have its own specific requirements.

Business protection is all about protecting a business from the problems that may arise if key individuals within the business or its owners suffer a critical illness, fall ill and cannot work, or die.

This means that the types of cover available to a business are very similar to those available to an individual. They are just used for different purposes, to benefit the business. Each business will have its own needs and in many instances the cover will have to be set up under trust.

Trading as a limited company

There are 2 core options for limited liability companies when it comes to protection.

Option 1 – Life of another

This is where a company can take insurance on a key employee on a 'life of another' basis.

If a claim is made, the insurance money is paid directly to the company.

Life or critical illness cover can be taken out in this way to cover a key person. So can key person income protection, to provide a regular income to the company if the key person is absent for any length of time through illness or accident. This can be used to fund sick pay, or to fund a temporary replacement.

However, the payment period is generally limited and it is not a suitable long-term salary replacement vehicle.

Option 2 – Own life in trust

Alternatively, if the key person is a business owner, they can take out a plan on their own life, written under business trust. This can be set up so that the benefits would then be paid to the other business owners via the trustees. The shareholders can then lend the money paid by the policy to the company. This can be used to offset the potential loss of revenue while they recruit a replacement. All of this is done by creating (or increasing) directors' loan accounts.

This is a very flexible method as it gives the directors a choice of when the money is loaned and how much is used. And because it is a loan, they can take the money back out of the company when the time is right, with no tax liability. But the downside is that the premiums have to be met out of post tax income. Furthermore, key person income protection should not be taken out using this method as the benefits would be payable to the ill shareholder instead of the company. If it is needed, it should always be applied for as a life of another plan.

Each shareholder could also take out income protection to protect their income if they are unable to work due to illness. This can be set up under a business trust to make sure it is always payable to the individual shareholder covered.

Trading as a partnership

There are two different ways of structuring key person cover for a partnership, depending on who is being covered.

For a partner

Each partner can take out a plan on their own life under trust so that the benefits are paid by the trustees to the other partners.

For an employee

In England, Wales and Northern Ireland, partnerships are not a separate legal entity. This means they cannot enter into a contract in the way a company can and have to set up this cover under trust. If the key person is an employee rather than a partner, then one of the partners can take out a life of another plan that pays the benefits to the partners.

This is not the case for Scotland, where a partnership is a separate legal entity.

Trading as a limited liability partnership

This is effectively a halfway house between a company and a partnership. While the taxation of the individual partners is similar to a traditional partnership, their liability is limited to the amount they have subscribed to the partnership.

A limited liability partnership has its own legal persona, so it can take out cover in the same way that a limited liability company can. This business format is becoming increasingly popular among professional practices, such as accountants and solicitors.

Trading as a sole trader

Sole traders are individuals, so they can take out cover the way an individual can. However, there are still some special considerations to take into account.

For the sole trader

Sole traders can take out a plan on their own life under a split trust, with their family as beneficiaries. This can include critical illness cover and would pay out to the sole trader if they suffered a critical illness. But if they were to die, the life benefit would go to the family.

The sole trader could also take out income protection to cover themselves.

For an employee

If the sole trader also has a key employee, then they can take out a life of another plan that includes life and critical illness cover on the key person. This would pay out the benefits to the sole trader in the event of a claim.

They could also take out key person income protection on the employee to pay out a regular income if the employee is absent through illness.

Other considerations

Before taking out cover, the business should record its intentions in the minutes of a board, members' or partners' meeting. Protection providers will often provide suitable wording for this.

It is also useful for clients to obtain written confirmation from their local Inspector of Taxes as to how any plan they take out will be treated for tax purposes. This is because the tax treatment of all protection plans is dependent on the specific circumstances of each business.



Before taking out cover, the business should record its intentions in the minutes of a board, members' or partners' meeting



If A suffers a critical illness and survives 30 days, £100,000 paid to A.
Or if A is unable to work because of sickness or an accident, £30,000 each year paid to A.

If A dies, £100,000 paid to A's family.

Information requirements

The information that advisers are asked for when setting up business protection plans will be similar to that for individual plans. However, the provider may also need further financial information too.

Insurance providers will normally set a limit under which they will not request any additional financial information. If this limit is broken, you could be asked to complete a business financial questionnaire, which may need to be countersigned by an accountant, solicitor or bank manager.

The questionnaire may ask:

- If any existing policies are in place for life, critical illness or income protection
- For the last 3 years' business trading figures and future projections
- For the total remuneration of the person covered in the last 3 years.

For loan cover, the adviser may be asked:

- To provide details of the loan
- If the term and amount of cover is different to the loan, why is this plan required?
- If the loan is to the business, why is the plan specifically on the person covered?

For key person cover, the provider may ask:

- For details of the effect on the business that the loss of this person would have
- How the amount of cover has been calculated
- How much of the gross profit has been attributable to the key person?

For ownership protection:

- What is the value of the business and who has performed this valuation?
- How many shareholders/partners/members are there?
- Are plans being taken out on all shareholders/partners/members?

Providers also set limits on how much cover can be taken out. For key person cover, for example, the cover may be limited to 7 to 10 times the salary package or twice the average gross profit, or maybe 5 times the average net profit. If more than one person is being covered, these limits may apply to the total cover.



Taxation

Advisers who arrange business protection for their clients may be able to apply for tax relief on premiums. This will vary according to the business set-up and the type of protection used.

There are a number of rules that apply to the taxation of business protection premiums, which differ depending on what type of business is involved and what type of plan is used.

Key person and loan protection

The tax treatment of premiums will vary depending on whether the business is a company, a partnership, a limited liability partnership or a sole trader.

Companies

HM Revenue and Customs will treat each case on its own merits. It is therefore always advisable to contact the firm's local Inspector of Taxes to find out the approach they will take.

Life of another

The key person cover and loan protection premiums will not be assessable against the key person for income tax or national insurance, as the potential benefits belong to the company.

The premiums may also be tax-deductible as a company expense if the plan meets the criteria shown in the table opposite. If the plan fails any of these criteria, the company is unlikely to find that the premiums are tax deductible.

If the premiums qualify for relief from corporation tax then the sum assured would be subject to corporation tax if it is paid out, as it would usually be treated as a trading receipt.

When working out how much cover is needed, the sum assured must be increased to cover the tax loss.

It is important to note that even if tax relief is not claimed for premiums that would have qualified, the sum assured may still be taxed as a trading receipt. Therefore, written confirmation should be obtained from HM Revenue and Customs that the premiums do not qualify as a business expense, and that the benefits will not be taxable. However, this may not always be forthcoming.

If a key person income protection plan meets the same 4 tests opposite, the premiums are likely to be tax deductible for the company. And if the benefits of the plan are used for profit protection, they are likely to be taxed as a trading receipt.

The same applies if the benefits are going to be used for sick pay, but in this instance, they will become deductible when paid out to the employee, thus cancelling out the tax. The employee will be taxed on their pay as normal and will therefore continue to be subject to income tax and employee's national insurance on the benefits. So if the aim is to use key person income protection for sick pay, a better solution may be for the key person to take the plan out on his or her own life instead, particularly as the maximum claim payment period for key person income protection is often just 5 years.



HM Revenue and Customs will treat each case on its own merits. It is therefore always advisable to contact the firm's local Inspector of Taxes to find out the approach they will take

The company could pay the premiums, which would be taxed as a benefit in kind, but the benefit would be tax free to the employee.

Companies

- **The purpose** of the plan is to solely protect against loss of profit
- **The sole relationship** must be employer/employee (although very small shareholdings – e.g. under employee share schemes – are likely to be ignored)
- **The plan** must be a short-term assurance, which is normally understood to be a non-convertible term insurance plan with a term of no more than 5 years
- **The sum** assured is reasonable.

Own life in trust

If the company pays the premiums, it can deduct the expense for corporation tax purposes as it is meeting a liability of a shareholder. But it will still have to pay employer's national insurance.

The shareholder who takes out the plan will be assessed for income tax and national insurance on the premiums.

When a claim is paid, the sum assured will pass to the trustees of the business trust free of taxation. There should not normally be any inheritance tax due, as this is part of a commercial arrangement. But a liability could arise if the money received from the plan is kept within the trust past the next 10 year anniversary of it being created (if the value of the trust is more than the then nil rate band).

If there is a positive director's loan account then premiums can be treated as a repayment of this loan, thus generating no further tax implication on that director. In this case there would be no corporation tax relief for the company.

The plan must be written under trust from commencement. It is not recommended that an existing plan is assigned into a business trust as this could give rise to a liability to capital gains tax.

Partnerships

If the life assured is a partner, the premiums are generally treated as being payable out of the partners' income after tax. As always, the plan must be written under trust from commencement. It is not recommended that an existing plan is assigned into a business trust as this could give rise to a liability to capital gains tax.

The premiums will not be assessable against the key person for income tax or national insurance if they are an employee of the partnership, as the benefits belong to the firm.

However, where the plan is set up as key person cover on the life of an employee of the firm, it may be possible for the partners to argue that this is a deductible expense, assuming it is paid by the partnership. This depends on the plan fulfilling the 4 tests on page 22 and being on the balance sheet as a partnership asset.

Some form of commitment to make sure that the proceeds would be payable to, and held as, a partnership asset may also be needed. So it could be advisable to contact the firm's local Inspector of Taxes to find out the approach they will take.

If the plan fails any of these tests the premium will not normally be tax deductible for the partnership.

The payment of the sum assured will only be treated as a trading receipt and subject to income tax if the premiums qualify for relief from income tax. So when working out how much cover is needed, the sum assured must be increased to cover the tax loss.

Key person income protection is likely to be tax deductible for the partnership if it meets the 4 tests highlighted in the box below. Any benefits paid out are likely to be taxed as a trading receipt in the hands of the partners. If the benefits are going to be used for sick pay, they are still likely to be taxed in the hands of the partners, but when paid out to the employee they would become deductible, cancelling out the tax.

The employee being covered by the key person income protection will be taxed on their pay as normal and they would continue to pay income tax and employee's national insurance. Therefore, if it is intended to use key person income protection for sick pay, it may be preferable for the key person to take the plan out on his or her own life. The firm could pay the premiums, which would be taxed as a benefit in kind, but the benefit would be tax free to the employee.

Partnerships

- **The purpose** of the plan is to solely protect against loss of profit
- **The sole relationship** should be employer/employee
- **The plan** must be a short-term assurance, which is normally understood to mean a non-convertible term insurance plan with a term of no more than 5 years
- **The sum** assured must be reasonable.

Sole traders

If the plan is written on the sole trader's own life, premiums will be seen as personal expenditure and will not be deductible as a business expense. This usually results in the sum assured not being taxable. But it may be possible for the sole trader to argue that the premiums should be a deductible expense if the plan is on the life of an employee and meets the 4 tests on page 23.

If such a claim is successful, then the payment of the sum assured may be taxable.

If the plan fails any of these tests, the premium will not be tax deductible. For example, if the key person cover is taken out for a capital purpose tax relief is unlikely to be granted on the premiums, even if all 3 other conditions were met.

If the premiums qualify for relief from income tax, then if the sum assured is paid it would usually be treated as a trading receipt and subject to income tax. So to provide a given level of cover the sum assured must be increased to cover the tax loss.

Key person income protection is likely to be tax deductible for the sole trader if it meets the 4 tests on page 23. The benefits are likely to be taxed as a trading receipt in the hands of the sole trader. If the benefits are used for sick pay, they would become deductible when the company pays them out to the employee, cancelling out the tax. However, the employee will be taxed on their pay as normal and would therefore continue to pay income tax and national insurance on the benefits. The sole trader would also still have to pay employer's national insurance. So if the aim is to use key person income protection for sick pay, a better solution may be for the key person to take the plan out on his or her own life instead, particularly as the maximum claim payment period for key person income protection is often just 5 years.



Currently, the business property relief for unquoted shares is 100%

Sole traders

- **The purpose** of the plan is to solely protect against loss of profit
- **The sole relationship** should be employer/employee
- **The plan** must be a short-term assurance, which is normally understood to mean a non-convertible term insurance plan with a term of no more than 5 years
- **The sum** assured must be reasonable.

Ownership protection

The taxation treatment will depend on the solution and the type of plan chosen.

Life of another

Corporation tax

Plans to cover company ownership will not meet the criteria for relief from corporation tax on the premiums. So when a claim is made and the sum assured is paid, it is unlikely to suffer corporation tax as it will not be classed as a trading receipt.

Capital gains tax

As long as certain conditions are met, the purchase of the shares by the company can be treated as a capital gain rather than a distribution for taxation purposes.

The advantage of this is that if the shareholder has died, the shares are valued at date of death. If the value of the shares has not increased between the shareholder's death and their sale to the company, the capital gains tax charge will be zero.

The conditions that need to be met are:

- 1 The company must be an unquoted trading company or the holding company of a trading group
- 2 The purchase should take place for the benefit of the company's trade
- 3 The purchase is not part of a scheme to avoid tax
- 4 The seller should be resident and ordinarily resident in the UK in the tax year of the purchase
- 5 The shares must have been owned for at least 5 years before the date of the sale (3 years if they were inherited)
- 6 The seller must not retain an interest of 30% or more in the issued share capital of the company
- 7 The vendor's interest should be substantially reduced – the holding after the re-purchase should not be more than 75% of the holding before the purchase.

The percentage shareholdings detailed above include shareholdings in the name of the vendor's spouse or minor children. It is important to remember in the event of a transfer of shares due to critical illness, that the critically ill shareholder may be liable to capital gains tax on any increase in the value of the shares over their acquisition costs. So it is vital that the company consults with their accountant before agreeing the purchase.

Inheritance tax

If the shares were sold because of the death of the shareholder, business property relief allows the transfer of 'relevant business property' at reduced rates of inheritance tax. In this context, relevant business property is unquoted shareholdings that have been held for 2 years. Unquoted shares are any shares not listed on the main stock market; alternative investment market quoted shares count as unquoted. Currently, the business property relief for unquoted shares is 100%.

Own life in trust

Income tax

If the individual shareholder or partner pays the premiums, this will come from their taxed income.

If a partnership is paying the premiums on behalf of a partner, the premiums will be treated as partnership drawings, unless they are deducted from the partner's capital, current or loan accounts.

If a company pays the premium on behalf of a shareholder, unless the premiums are deducted from a director's loan account, the premiums will be considered a benefit and assessed for income tax and national insurance.

Corporation tax

If the company pays the premium it can deduct the expense for corporation tax purposes as meeting a liability of a shareholder.

Capital gains tax

No personal liability arises, as long as the plan is written in trust from commencement. If an existing plan is assigned into trust under a commercial arrangement it could be argued that the trustees acquired the plan for money or money's worth. Any subsequent disposal by them, including a claim on the plan, could therefore give rise to a liability to capital gains tax as the original beneficial owner is not disposing of the plan and it was acquired for money or money's worth.

Inheritance tax

The plan should be written in trust from inception. A plan is not normally subject to inheritance tax if it is written under trust as part of a bona fide business arrangement on commercial terms. The evidence of the business arrangement is the cross-option agreement in single and/or double option format and the similar plans effected by the other shareholders or partners. It may also be desirable to equalise premiums. It is essential that no one outside the business arrangement should be included as a beneficiary under the trust to maintain commerciality.

A liability may arise if the proceeds of the plan are still held in trust past the next 10 year anniversary of the trust being created. This could happen if, for example, a payment is made on critical illness, but the ill owner does not immediately exercise their option to sell their share of the business. The plan proceeds could remain in the trust for future use by the other owners should the ill owner not return within 12 months. And the other owners then have an option to buy his or her share of the business.

If a single or cross-option agreement is used, business property relief is available. This allows the transfer of relevant business property at reduced rates of inheritance tax. In this context, relevant business property is unquoted shareholdings that have been held for 2 years or a partner's share in the business. Unquoted shares are any shares not listed on the main stock market; alternative investment market quoted shares count as unquoted.

Business property relief for unquoted shares or a partner's share in the firm is currently 100%. If a buy and sell agreement is used then business property relief would be lost. This is because it is regarded as a binding contract for sale. Under this, business property relief is not available because the value of the business is regarded as cash in the estate of the deceased owner. If the business is a family business, inheritance tax and business property relief are unlikely to be affected as long as the arrangement is solely to protect the business and is arranged to protect only those with direct shareholdings.

Glossary

Automatic accrual: an agreement under which the value of the goodwill in a partnership automatically passes to the other owners without payment by them.

Capital gains tax: a tax on capital gains, which is normally only paid when an asset is disposed of.

Cross option/double option: an agreement that gives both buy and sell options.

Director's loan account: a loan made by a director to the company. This can be made up of money actually loaned or undrawn salary or dividends.

Goodwill: the value of a business attributable to future income, based on factors such as market name and customer loyalty. Not usually shown in the balance sheet.

Inheritance tax: a tax that may be payable on an estate when someone dies, or when assets are transferred into a discretionary trust or to a company.

Key person protection: loss of profits insurance that provides a company with the proceeds from an insurance policy so it can continue trading if a key person dies or becomes critically ill.

Life of another: a life assurance policy taken out on the life of another person by the policyholder.

Loan protection: ensures a loan is repaid on the death or critical illness of a key member of the business.

Menu plan: different protection policies are covered under one plan.

Own life in trust: a policy taken out by an individual on their own life and placed in a trust for the benefit of a range of potential beneficiaries.

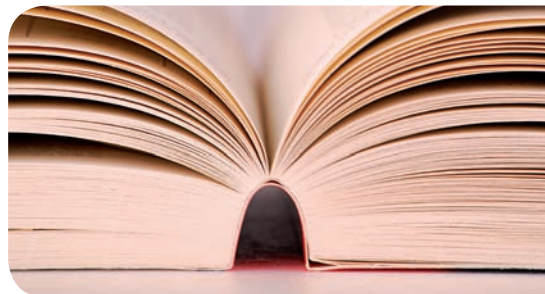
Partnership protection: if a partner dies or becomes critically ill, a cash sum will become available so that the other partners can buy their interest.

Shareholder protection: on the death or critical illness of a shareholder, the other shareholders will receive a cash sum to buy their shares.

Single option: an agreement that gives a sell only option.

Sole trader protection: a sole trader can apply for an own life policy and place it in a flexible trust for the benefit of their family. If critical illness is included, the proceeds will be paid to the sole trader to keep the business afloat while they are ill.

Trading receipt: business income that is used in calculating the potential taxable profit of the business.



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