Business Succession

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NW BROWN
EMPLOYEE BENEFITS

What are the risks to your business?

Key Personnel

If a key person in your business dies, your profits may suffer. This may be because the individual played a key role in generating new business and had strong relationships with important contacts. It could be the loss of their skill in running the business or even the additional financial burden of outstanding loans. It takes time and money to replace key staff not to mention a period of adjustment for somebody entering into the role.

Shareholders and Partners

A lack of business protection for major shareholders could have even more impact. The deceased's beneficiaries may want to become involved in the business and this may be extremely disruptive. You might have to re-allocate funds already set aside for other purposes so that you can purchase the deceased's interest or shareholding, or you may need to find a third party to provide the cash to buy out their share of the business.

Sole trader

A sole trader business automatically comes to an end. The business may still have a value – stock, buildings, or assets such as equipment and vehicles and goodwill, but the business itself will legally cease. The business assets will form part of the sole trader's estate and pass on to beneficiaries under the terms of their will. If the estate is large enough (currently over £325,000, including the value of any homes, business and other assets) and is not left to a spouse or civil partner, then, subject to some exemptions, inheritance tax (IHT) is payable on all assets above £325,000.

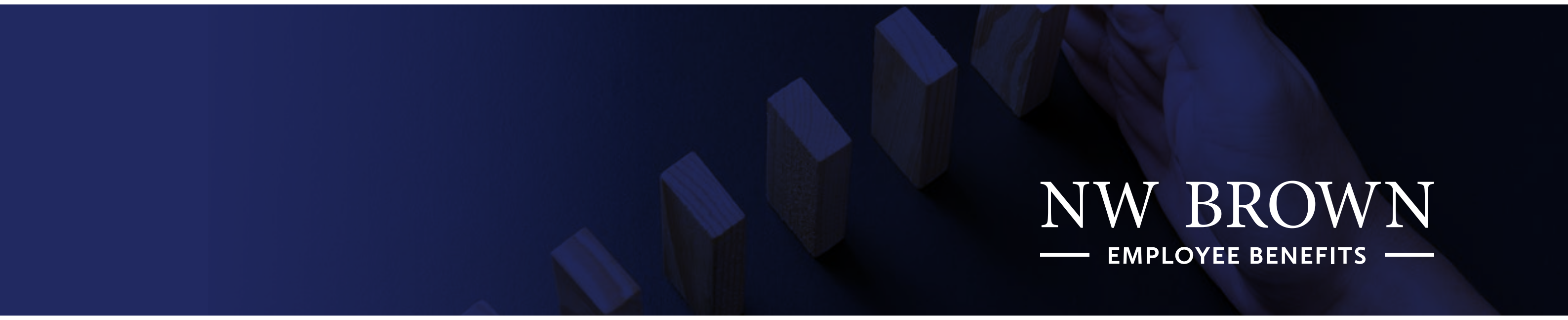
The main issues that can arise are paying any inheritance tax bill and passing on the business, perhaps to an employee or a family member. In both cases, the requirement is for a lump sum of money, which can be achieved through a suitable life insurance policy. We generally recommend that a sole trader takes out a life insurance policy on their own life and either assigns it to the beneficiary or sets up a trust to pay the beneficiary on their death. The exact solution will depend on individual circumstances.

Partnership

A partnership is a business owned by two or more people. Unless specific provision is made in the partnership agreement, the partnership will cease on the death of a partner. When that happens, the deceased partner's estate becomes entitled to their share of the business. The remaining partner/s may have to pay the deceased partner's estate the value of the deceased's share.

Alternatively, the surviving partner/s and the deceased partner's beneficiary could carry on in business together, whether or not the new partner has any interest or skills in the business.

Two main options are available to meet such needs, illustrated below using the example of a simple two- partner business owned by A and B:



The first is a double option agreement. Here, the surviving partner has the option to buy the share in the business from the deceased partner's estate – in other words, they can make the estate sell the share. The deceased partner's estate can also exercise an option to force the surviving partner to buy. Generally, each partner takes out a life insurance policy on his or her own life, written under trust to benefit the other partner. So if A dies, B can decide to buy out A's share from the proceeds of the policy on A's life.

The second option is automatic accrual. Here, on A's death, the business passes automatically onto B. No buy- out is involved. Instead A's beneficiaries get the proceeds from a life insurance policy A took out on his or her own life, written in trust for his or her beneficiaries.

The end result of both solutions is that the remaining partner continues to run the business and the deceased partner's beneficiaries receive a fair price. Without these arrangements, the business could be in danger and the beneficiaries might receive little or nothing.

Limited company

Companies continue after a shareholder's death, but the basic succession issues are similar to those facing a partnership. The key is to make sure that the shares end up with the surviving shareholders and the deceased shareholder's family receives some money. Generally, the deceased shareholder's beneficiaries will want financial compensation in return for their shares, assuming that they do not plan to continue in the business.

A cross option agreement is often used for company shareholder succession planning. If shareholder A dies, their beneficiaries can require the remaining shareholders to buy them out or the remaining shareholders can require the beneficiaries to sell their shares. One advantage of cross options is that they do not affect entitlement to inheritance tax business assets relief. So the deceased person's shares pass down to the estate tax-free – unlike most other assets.

What if the business owner is seriously ill?

It is not just the death of a business owner that can affect a business. If a business owner suffers a critical illness such as a heart attack or cancer, it may not be possible for them to continue in the business.

A suitable critical illness insurance policy is often the best way to provide protection against the financial consequences of having a serious illness. These policies pay a cash lump sum on diagnosis of a specified critical illness or disability. The policies are normally written in trust for the other business owners, and an agreement is needed between the business owners about the circumstances in which the share in the business should be transferred.

How can we help?

When we advise clients about business insurance and succession planning, we start by finding out the most important issues in each individual case. Once these have been identified and prioritised, we can then recommend a suitable protection strategy. This will include the options available, their costs, any tax implications and the methods of valuing the business.

For more information, please call us on 01223 720 209 or email info@nwbrown.co.uk