Pareto
ALL MATTERS FINANCIAL

TYSERS

A GUIDE TO CORPORATE PROTECTION

Help protect businesses from financial losses

A business is built by its people. One of the greatest risks to any business, but particularly a small business, is the critical illness or death of an owner or key person, but few firms have sufficient cover in place to protect themselves.

Whilst people often take steps to protect themselves and their families, not all business owners are fully aware of the options available to safeguard their business. The unexpected loss of a key person is likely to have a significant impact on business continuity and profitably, and may even lead to its closure.

Business Protection is, in essence, a business survival policy designed to protect the owners against the impact of unforeseen circumstances on their firm. It can be configured to meet a firm's specific business needs to provide a straightforward, cost-effective and, in some instances, tax-efficient way for businesses to protect their future.

Types of business protection include:

- **Key Person Cover** - To help a business replace a key person and cover potential loss of profits.

- **Shareholder Protection** - To ensure remaining business owners can purchase the shares from the estate of the deceased or the critically ill shareholder.

- **Relevant Life Protection** - Proceeds paid directly into a relevant life trust for the benefit of their dependants and family.

- **Business Loan Protection** - Policy proceeds used to pay off any loans/personal guarantees or director loans the business may have.

KEY PERSON COVER

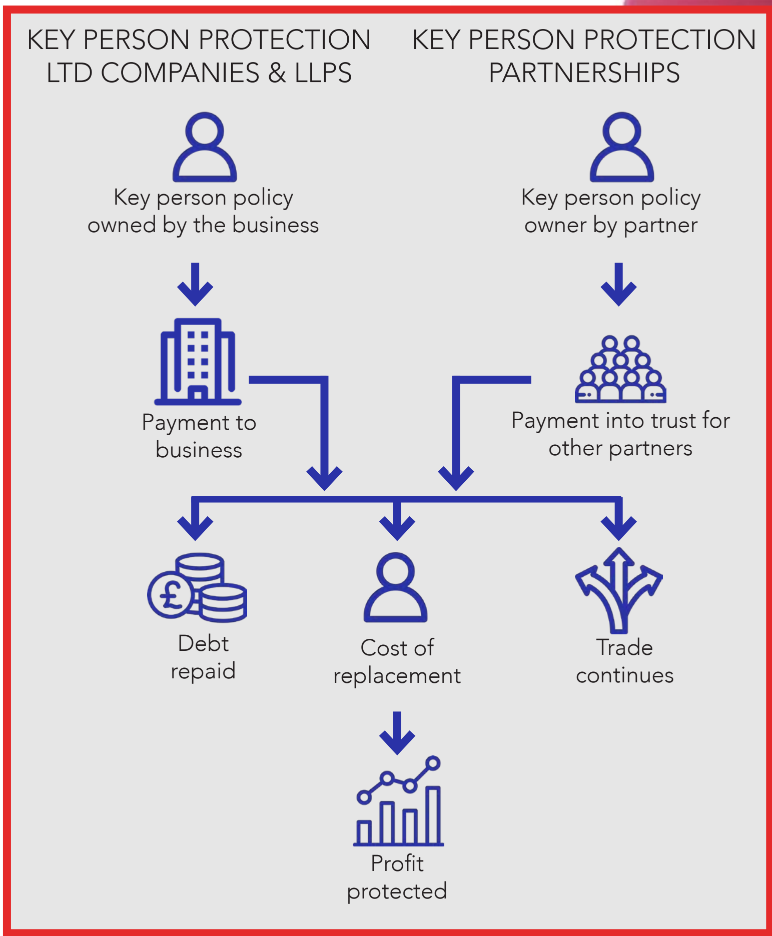
Key people are those who are crucial to ensuring a business can trade and generate profits. They may be owners, directors, managers or specialist employees. If they were to become critically ill or die, there may be a significant impact on the firm.

Key Person Cover can help ensure that sufficient funds are available to keep the business operating, cover the cost of replacing a key person and provide additional capital to repay any outstanding commercial debt.

Key person protection can be arranged for limited companies and limited liability partnerships without the need for a trust. The key person is the life assured and the business owns the policy, so any claim proceeds are paid to it directly.

Why take it out?

When a key person dies or suffers a critical illness they often need to be replaced. The recruitment costs can be expensive, and it can take a long time. The loss of revenue caused by the disruption may hinder the business's ability to repay its loans and other liabilities, a responsibility that often rests with its owners. Key person cover helps to maintain the confidence of a business's customers, suppliers, and lenders.



CASE STUDY

Scenario

Our client, a 41-year-old married business owner with a young family had recently taken over a company. Unfortunately, the client had some very bad health news in March 2021 and wanted to look at the protection in place to ensure his family would be ok financially.

Solution

The client had Key Person protection in place as well as death in service via the company, and personally the client had mortgage protection and a pension death payment.

The client decided to sell 75% of their shareholding to a new business with existing management team to realise a sum of money from the business.

Outcomes

- Business retains current management team and can continue to trade uninterrupted due to succession planning in place.
- Income to continue from the business to the client's family from the remaining 25% shareholding.
- Money from sale of business and protection pay outs to be invested.
- Family's income will be the same as what the client previously received meaning that they can continue with a similar lifestyle – providing much needed peace of mind for the client that his family will not struggle financially.

SHAREHOLDER PROTECTION

Control over ownership is one of the primary considerations of business protection. However, ensuring that the value of your share in their business is passed on to your family is equally important.

Losing an owner can have a huge impact on the day-to-day running of a business and can quickly result in financial difficulties. Boardroom confusion can lead to conflict in decision making - the surviving owners and the deceased's family may have very different ideas about the future of the business.

Depending on whether the business is a limited company, LLP or partnership, there are various methods of arranging protection to cover both the critical illness or death of a shareholder, member or partner.

Business owners will usually wish to pass on their shares to relatives in the event of their death. Shareholder protection can provide enough money to ensure that relatives receive an agreed payment for their share. This allows the surviving owners to maintain control of their business.

In the event of an owner becoming critically ill and wishing to leave the firm, the insurance can provide sufficient funds for them to receive cash in exchange for their shares.

Why take it out?

Shareholder protection policies help protect both the owners and the company in the event an owner becomes critically ill or dies. If an owner suffers a critical illness, the company/co-owners will receive a payment which enables them to purchase the shares of the critically ill shareholder. On the death of an owner, the company/co-owners will again receive a payment enabling them to purchase the shares of the deceased owner, whose estate receive value for the shares. The company/owners are protected as they're able to keep control of the business and don't need to find additional funds to make the payment.

What is Automatic Accrual?

Some owners of professional practices, such as chartered accountants or solicitors, are unable to pass on their share to their families. The requirements of their business mean that only qualified individuals can become members or partners.

There will usually be an agreement to automatically transfer the deceased's interest in the business to the surviving owners. Individual members or partners may consider an insurance policy on their own life to ensure that their family receives a payment equal to the value of their share, as there will be no payment from the surviving business owners. This also means any proceeds of claim are usually not subject to Inheritance Tax and settlement can be made quicker, due to probate not being required before the payment is received.

CASE STUDY

Scenario

Two shareholding directors in a company were unsure of the company value. They were both in their 50s and both married with children. They had no shareholder protection.

The shareholder agreement said that in the event of the death of a shareholder the company had to buy back the shares at the market value. However, there was insufficient capital for either surviving shareholder to buy the shares should one of them die.

Solution

The business was valued at £6 million. Pareto Financial Planning set up shareholder protection for £3 million each on own life basis in a trust with the other shareholder as trustee and the company as beneficiary. We also updated articles and shareholder agreement and wrote a Business Will and Power of Attorneys (POAs).

Sadly, one shareholder died 4 years into a 10-year plan. As there was shareholder protection in place the shares went to the deceased's spouse.

Outcomes

- Monies paid out to the trust and the surviving shareholder was able to buy the shares from the deceased's spouse for £3 million.
- The deceased's family had financial stability from the sale of the shares.
- The surviving shareholder owned the company outright, there were no succession issues and no interruption to the business.

RELEVANT LIFE PROTECTION

Businesses owners and company directors with too few employees for a group death in service scheme may benefit from setting up relevant life policies which provide valuable life cover as a multiple of remuneration. Cover can be arranged for any employee and funds are paid to the trustees and distributed to the family.

The basics of Relevant Life policy:

- The cost of the plan is normally an allowable expense for the business meaning the business gets tax relief on the premiums paid.
- No assessment of premiums on the employee as benefit in kind or otherwise.
- Premiums paid do not count towards annual pension contribution limits.
- In most cases benefits are paid free of inheritance tax.

Why take it out?

Relevant Life Plans allow you to provide employees (including directors) with tax efficient death in service benefits without the need for, or alongside, a pension scheme. They can be particularly beneficial for small businesses that don't have enough eligible employees to warrant a group life scheme.

CASE STUDY

Scenario

Our client, the owner of a restaurant was looking to expand his business into the vacant shop next door. To do this he needed to borrow £750,000 from the bank.

It was concluded that if he were to pass away, the business would have to repay the debt because there would be no way the business could carry on running, therefore leaving his family at financial risk.

Solution

The client took out an insurance policy on his life to pay out the outstanding loan amount. The policy was over 15 years which is the term of the loan and will pay out if he dies during this term.

Due to the client owning the life policy on a 'life of another' basis, there's no need for Trust documentation to be completed. In the event of a claim, the benefit would be paid directly to the restaurant or the bank, therefore it's not treated as a benefit in kind for the client.

Outcomes

- Family protected financially in the event of our client's death.
- Loan will be paid back in full to the bank.

BUSINESS LOAN PROTECTION

If a business owner, Director or key person within a business die, lenders may demand that any outstanding loans are repaid. Business loan protection can help secure the business's viability by providing a lump sum to cover any outstanding borrowings such as a loan or commercial mortgage.

In addition to paying out if the insured person passes away, many business loan protection policies include critical illness cover, which means the company's debts would be paid off if the insured person was unable to work due to contracting a serious illness or health issue that is listed in the terms and conditions of the plan.

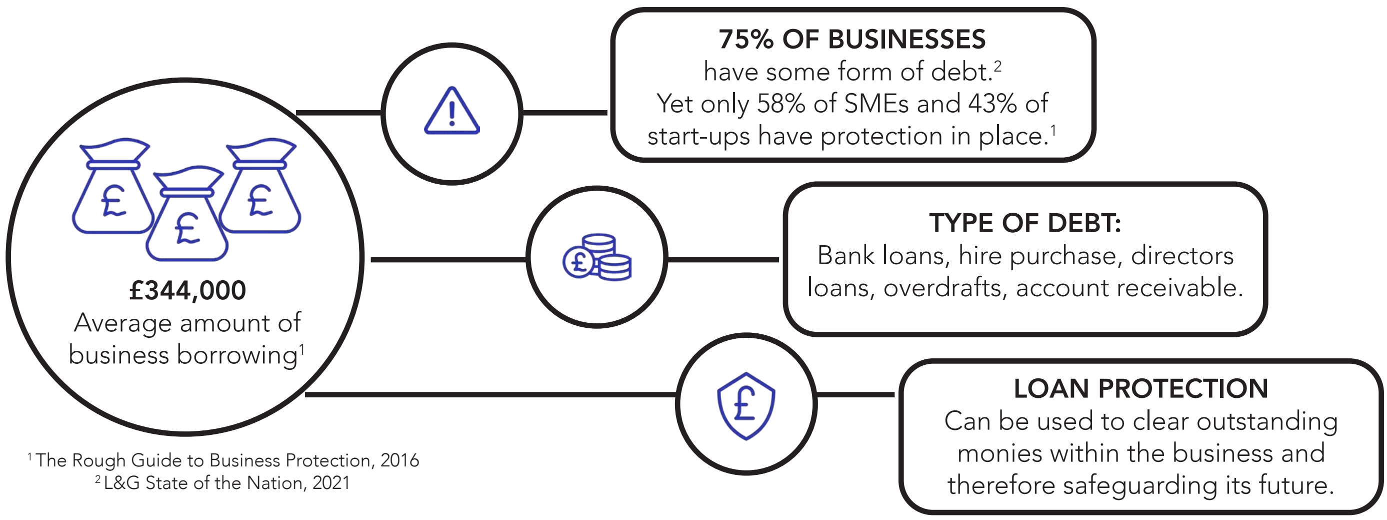
Similar to a personal life insurance policy, it is designed to pay out to the value of the loan providing the company with the funds to repay the loan. Considering that some business loans may include personal liability this is a crucial insurance to protect individual directors from any potential loss.

The basics of Loan Protection:

- Paid to the business or directly to the lender.
- 'Decreasing cover' (premiums fall in line with the repayment of the loan) or 'level cover' options (normally used for interest-only loans) available.
- Protects your businesses cash-flow.

Why take it out?

Business loan insurance is not compulsory in the UK. However, for businesses that heavily rely on business owners or shareholders to be able to meet the repayments of outstanding debts, it is worth considering. Especially if any of these loans have personal guarantees which could leave members of the business financially vulnerable should the business no longer be able to meet the loan repayments.



[1] The Rough Guide to Business Protection, 2016
[2] L&G State of the Nation, 2021

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