ADVISER GUIDE TO BUSINESS PROTECTION

EFFECTIVELY PROVIDING FOR KEY PERSON COVER AND OWNERSHIP PROTECTION

Contents

About this document		3
1.	Introduction	4
2.	Business Protection in context	4
3.	Key Person Cover and solutions in detail	9
4.	Ownership protection on death: needs and solutions for business owners	13
5.	Ownership protection on serious illness or disability: needs and solutions for business owners	15
6.	VitalityLife Business Trust in detail	17
7.	VitalityLife draft cross option agreements for purchase on death in detail	19
8.	VitalityLife draft option agreements for share purchase on serious illness or disability in detail	23
9.	Company share purchase – special considerations	26

About this document

Many businesses rely on certain key people to trade, without whom they would struggle financially. Just as a business insures its assets against fire and theft, it should also consider protecting itself against the death, serious illness or disability of its key people. This guide gives you useful information about VitalityLife's Business Protection solutions to help you protect your client's business.

1. Introduction

VitalityLife recognises that business owners have special protection needs. This is because, in the event of the death or serious illness of a business owner who is involved in the running of the business, as will be the case for most small to medium private businesses in the UK, or the death or serious illness of a key employee, it is not only the Key Person or their family and dependants that will be affected financially but also the business.

The continuation of the business and, in multi-owner businesses, the destination of the business share owned by the deceased or seriously ill owner are two fundamentally important issues that need to be planned and provided for.

The VitalityLife Business Protection solutions are designed around our innovative Business Protection Plan. In a business context it is expected that the plan would be used by business owners ("Owners") to provide the funds needed for either one or both of:

- Business share purchase or financial compensation in the event of one of the Owners dying or becoming seriously ill ("Ownership Protection").
- Financial protection for the business following the death or serious illness of a working Owner or a key employee ("Key Person Cover").

To ensure that the funds are available in the right hands following the insured event it is often not sufficient to just effect a policy.

With this in mind VitalityLife not only provides what we believe to be an innovative and "business-appropriate" life assurance and serious illness solution but also essential supplementary draft documentation in the form of the draft Business Trust, draft Partnership Trust and several draft Option Agreements to be used depending on the circumstances of the business owners:

- To provide Ownership Protection solutions for partnerships, limited liability partnerships (LLPs) and companies, and
- To provide Key Person Cover solutions for partnerships and LLPs and companies where the life assured is a business owner or an employee.

For sole traders a separate Discretionary Trust is available.

The purpose of this guide is to explain the fundamentals of Key Person Cover and Ownership Protection for sole traders, partners, LLPs and companies. We consider each need and solution in the context of each type of business owner.

We then look in detail at the VitalityLife solutions to these needs. Where appropriate (and especially in connection with Ownership Protection) we also explain the VitalityLife Business Trust, the Partnership Trust and Option Agreements, how they work, how to implement them and their tax implications. All this is to help you fully understand and be able to explain how your business clients' objectives, in relation to Key Person Cover and Ownership Protection, can be best achieved.

2. Business Protection in context

2.1 Business structures

In order to ensure that correct arrangements are put in place a good starting point is to understand the different types of business structure through which you can trade in the UK. There are four main business structures: the sole trader, the partnership, the limited liability partnership (LLP) and the limited company. Being clear about the type of business you are dealing with (including how it is structured and how it operates) helps you to create and present clear solutions.

2.1.1 Sole traders

"Sole trader" or "sole proprietor" means a business that is owned and controlled by one person who takes all the decisions, responsibility and profits from the business that they run. Although most sole traders will be relatively small businesses, many will have employees, who in some cases can also be "key" and so this form of business, ie. Key Person Cover on the life of an employee of a sole trader, should not be overlooked.

2.1.2 Partnerships

Section 1 (1) of the Partnership Act 1890 defines a partnership as **"the relationship which subsists between persons carrying on a business in common with a view of profit"**.

Partnerships may vary in size, for example, from as small as two people with no employees, to large accountancy practices with hundreds of partners and staff. Each partner will have two financial interests in the business - an entitlement to a proportion of the profits of the business and an entitlement to capital. Capital will include any goodwill in the business. Goodwill is an intangible asset which reflects the relationship of the business with its customers and its good name as a business. In most cases, the percentage entitlement of each partner will be the same for both profits and capital but this does not necessarily need to be the case. Regardless
of the size of the undertaking, similar financial responsibilities and obligations apply to partners.

In England a partnership (except for a LLP) does not have an individual legal identity distinct from the individuals who constitute the partnership.

The operation of the partnership, including the rights and obligations of the individual partners, will usually be dealt with in the partnership agreement.

Where there is no partnership agreement, the above mentioned Partnership Act 1890 will apply. This Act sets out various rules for how partnerships are defined, run and dissolved (brought to an end). However, save for certain rules in relation to the firm's relationship with the outside world which cannot be avoided, e.g. partners' unlimited liability for the firm's debts, partners can choose to operate in a different manner, so long as there is an agreement between the partners so to act.

For example, the Partnership Act sets out the general principle that a partnership will be dissolved by the death of any one of the partners. The capital and profits of the business would be shared equally between the surviving partners and the deceased partner's estate.

Clearly this is not practical for most businesses, and the situation can be avoided simply by the partners agreeing to act in a different way. Ideally, the partners should set this out in a written partnership agreement. This will cover matters such as the name, nature and place of business, the inter-relationship between the partners (e.g. how the profit and capital is to be split) and the procedures for reorganising the partnership following the death, incapacity or retirement of a partner.

From a Key Person Cover and Ownership Protection standpoint there are some very specific issues to consider when dealing with partnerships. Key Person Cover can't be effected by the partnership, except in Scotland, where Scots law partnerships have what is known as a separate legal persona and, thus, contractual capacity. However, Key Person Cover can be effected in such a way that the Plan and its proceeds are treated as a business asset. This is done using a special Partnership Trust.

2.1.3 Limited liability partnerships

A limited liability partnership (LLP) is a form of partnership that has evolved in response to a desire to limit the business liabilities of the partners but where a corporate structure is inappropriate or impossible due to the rules of, say, a professional body. It is thus common to see this structure used in the accounting and legal professions.

Under the Limited Liability Partnership Act 2000 it has been possible to incorporate an LLP with effect from April 2001.

An LLP has a separate legal persona – like a company – and this brings with it the ability to contract in its own right.

However, the members of an LLP (as they are called) are taxed as a partnership would be - that is, all profits, drawn or not, are taxed on the members as trading income in accordance with their profit sharing provisions.

The fact that an LLP can enter contracts means that it can effect Key Person Cover in its own name.

The Ownership Protection needs, on the other hand, will normally be provided for in exactly the same way as for partners in conventional partnerships.

2.1.4 Limited companies

The Companies Act 2006 describes a company limited by shares as "**a company having the liability of its members limited by the memorandum to the amount, if any, unpaid on the shares respectively held by them**".

So, the owners of the company are the shareholders.

The total liability of a shareholder for the debts of a company is limited to the unpaid value of the shares he or she holds. Usually, although not always, shares are fully paid. This means that the shareholder has no further liability for the debts. The worst that can happen is he or she can end up with shares that are worthless. Of course, this will not be the case if the shareholder has given a personal guarantee which will often be required by a lender to a private company.

This is a very different situation from a partnership. In a partnership, each partner is liable for the full debts of the partnership. This means that once the partnership assets have been used to pay partnership debts, creditors can claim against the personal assets of the partners.

To manage the company, the shareholders appoint directors. There must be at least two directors for a public limited company, and at least one for a private limited company. The directors do not necessarily have to be shareholders themselves, although in small companies it is usually the case that they do own shares – and in many cases all the shareholders are also directors.

A limited company has a separate legal identity, distinct from the individuals who own shares in the company. This also applies for tax purposes: a company is subject to corporation tax on its profits and gains. Shareholders take their profits by way of dividends and directors and employees are in turn taxed on the remuneration they receive. Again, this is very different from a partnership, although the concept of the limited liability partnership does bridge the gap.

Each company must have legal documents which are called the Memorandum and Articles of Association.

These are two separate documents. The Memorandum of Association will state the company's name, where the registered office is situated, the objects of the company, the fact that the shareholders' liability is limited and the details of the share capital. In effect this sets out the relationship of the company with the outside world.

The Articles of Association are much more concerned with the internal rules and regulations of the company. They contain such details as the powers of the directors and how these can be exercised, the procedure for the transfer of shares and the voting rights of the members. Because the company has a separate legal identity, the death of a shareholder will not mean the dissolution of the company. Whoever inherits the shares will be the new shareholder.

People use companies to carry on a trade for two main reasons.

1. For limited liability which means that, subject to any personal guarantees given in their capacity as shareholding directors, the owner/managers can limit their liability to the amount committed to the company as share capital.
2. For lower tax rates on retained profits than if the profits were received by the owners as traders outside of a corporate structure. The maximum rate of corporation tax is 21.25%, compared with the 45% maximum personal rate of income tax.

2.2 Key Person Cover needs and cover – outline

Who is the "key person"

The term "Key Person Cover" has been used to denote a life assurance policy taken out by a company on the life of one of its employees or directors. Despite the existence of these terms, there is no legislative definition of the policies used to provide this cover or any reference to key person or other such policies in any legislation, regulations or case law.

In many small, privately-owned businesses, the persons whose loss would cause the greatest financial damage to the business would be the owners, i.e. usually the partners or shareholders – normally shareholding directors. Of course, where the business is run as a sole tradership, the most important key person is also likely to be the owner.

Given that the main criterion to "qualify" as a key person is that the person's death or serious illness would cause serious loss of income or profit for the business, employees of all types of business, particularly those with special knowledge or skills, can, of course, also be key persons. In practice, though, such employed "key persons" are less likely to be encountered in small businesses.

In professional partnerships it may well be that as well as the partners some of the firm's employees could be key persons. Particular attention needs to be given to 'salaried' partners, who although referred to as partners (and in practice in due course would often be offered an equity interest in the firm) are in reality employees of the firm.

The extent of the cover need

In calculating the extent of any Key Person Cover need, you will be focusing on the need for liquidity on the death or serious illness of the identified key person. The recommended approach is to draw up a checklist of 'reasons why' funds may be needed on either of these occasions. These 'reasons why' will include:

- Loan repayment
- Replacement of lost profits
- Cost of recruitment of replacement personnel
- Repayment of partners'/directors' loan accounts

To arrive at the required level of cover, each of these needs must be quantified for each key person.

How to effect cover

There are different ways of effecting Key Person Cover depending on the structure of the business and whether the key person is an Owner. If the business is run as a limited company it would be usual for the company itself to effect the policy on the Owner's life. If the business is a partnership, it would be usual for a partner to effect the policy on their life subject to a special Partnership Trust for the "partners for the time being". For a LLP, as it is a separate legal entity, policies could be effected by the LLP on the life of themember.
If partners are also effecting ownership protection cover subject to Business Trusts, Key Person Cover can be added on to the same arrangement. For a sole trader the policy would usually be held on a "personal" Discretionary Trust under which the beneficiaries are the family/dependants of the life assured.

Where the key person is a "non-owning" employee, the company or partners or sole trader could effect the policy on the life of the key person.

For an Owner, other than a sole trader, the cover can be provided for both the ownership protection and Key Person Cover under the same policy. Clearly, it is important that the parties record, in some form of memorandum, the reasons for the cover and the levels of cover required for the continuation need and the succession need.

However, there is in principle no reason why one policy should not provide for both needs unless not all the partners are considered "key persons" in which case the Partnership Trust (or company-owned policy) should be used.

This would usually be the method adopted where the Owners are partners.

Tax implications

Except where the life assured is a "non-owning" employee, the premiums paid will not be tax deductible. If the premium is deductible (ie. under an appropriate policy on the life of a "non-owning" employee to meet a revenue loss), the benefits would usually be assessable to tax.

Where funds for the Key Person Cover needs are provided under a policy in a Business Trust for the Owners, then once the policy benefits have been paid out following the death or serious illness of the Owner, the Trustees would normally make the payment to the remaining Owners who would then inject the funds into the business, usually by way of a loan.

This may represent a tax-efficient method of using such funds since any subsequent loan repayment from the business to the Owner would be tax free. However, the higher post-tax cost to the business of providing cover on this basis would need to be taken into account.

Proceeds of a policy held subject to a Partnership Trust will belong to all the partners at the time, ie. be a business asset. Payments under a sole trader's policy Trust to their family will be made by the Trustees.

For more details see section 3 of this guide.

2.3 Ownership Protections and share purchase – outline

2.3.1 Sole traders

For most sole traders the business will cease when they cease to be involved eg. on death or cessation of work on suffering a serious illness.

However, in some cases, the business will continue and thought will need to be given to "succession" as well as compensation. One obvious example is where, say, a continuing business is to be left to a son/daughter leaving a need for compensation for another son or daughter (who is not inheriting) or, say, a spouse who does not want to be dependent on or a "burden" on the "new owners". In either case inheritance tax (IHT) is unlikely to be a problem. Where the business is wholly a trading business it will usually qualify for business property relief and if it passes to a spouse or civil partner then, regardless of its trading status, it will be exempt.

So, having established that there will rarely, if ever, be an IHT problem in relation to the value of the business, all that will be required from a financial provision standpoint will be a simple policy in Trust for the person(s) to be compensated.

Another desired outcome might be for the business to pass to the sole trader's employees rather than the family or dependants. One (obvious) way for this to happen may be for the employees to buy the business from the deceased's estate on death or from the owner following a serious illness. Capital gains tax should be nil or minimal in a transaction following death as the business will have been revalued on death. However, CGT could be meaningful in a lifetime transaction - following serious illness - although entrepreneurs' relief would reduce the tax otherwise payable. The actual tax payable in any case will depend on the facts.

Whenever the sale takes place, having access to funds would be fundamentally important for the employees though. In this case they may care to put appropriate cover in place on the life of the Owner to provide the funds when required.

Dependent on how the "right to buy" is documented then either the purchasing employees could effect the policy or it could be effected by the Owner and assigned to the employees or made subject to Trust for them with the employees meeting the premium payments.

For any succession arrangement involving a transfer of business to employees, professional advice is essential.

2.3.2 Partners and shareholders

Regardless of whether the business is run as a partnership (including an LLP) or limited company, where all the Owners are members of the same family, eg. parents and children, and it is to stay that way, then there will normally be no problem with succession when one of the Owners dies or becomes incapacitated - the others will probably simply take over, with the family usually looking after the dependants of the deceased or incapacitated Owner.

However, in businesses ran by unconnected parties (or families where succession is not assured) the death or incapacity of an Owner is likely to cause serious disruption and problems, for both the business and the family of the Owner concerned.

In relation to the death of a shareholder or a partner, ideally there should be an agreement to purchase the deceased Owner's share of the business by the surviving Owners. Usually the agreement would take form of a "double option" under which the executors of the deceased Owner would have an option to sell and the continuing Owners an option to buy. Either party exercising their option would force the sale.

A more recent development is the acknowledgement that serious problems for a business can also arise on the incapacity of an Owner and similar arrangements are often put in place to deal with such an eventuality.

Where the business is run as a limited company, there is an additional possibility that may need to be considered in certain circumstances, and that is the company itself buying the shares of the deceased or incapacitated shareholder.

2.3.3 Special arrangements where shares are owned by a non working spouse

In many businesses, often for tax reasons, Owners choose to share the entitlement to the capital (and often income) of the business with their spouses who are not directly involved in the running of the business. In such circumstances, it is anticipated that on the death of a non-working Owner, they would leave their shares to their spouse via a Will.

However, the working Owners may require an agreement which would provide that if one of the working Owners were to die, the other working Owners would have the option to buy the share of the deceased as well as the share of the spouse of the deceased. VitalityLife provides draft option agreements that allow for such an arrangement in the event of death or serious illness of a working Owner.

3. Key Person Cover needs and solutions in detail

3.1 Sole traders

3.1.1 General

In the majority (but not necessarily all) of cases the financial compensation solution required for sole traders looking to protect themselves and their family against the financial risk resulting from the serious ill health or death of the sole trader will be an appropriate personal protection strategy. Self-evidently, if Income Protection Cover is put in place for a sole trader this will need to be for their benefit and so no Trust would normally be needed.

The required sum assured should be arrived at by determining the income/capital needs of the family and dependants. The Trust should, of course, not be a "Business Trust" but a "Personal" Trust – most probably a Discretionary Trust but possibly a bare Trust if the sole trader knows for sure who they want to benefit and is happy that no change of beneficiary can be made.

For stand-alone serious illness lump sum cover, no Trust would be needed although it should be explained that should death follow soon after a serious illness the unspent benefits would be included in the taxable estate of the life assured.

For a policy providing death cover, a personal flexible or discretionary Trust would be required.

Where a policy is set up to provide benefits on the first to occur of the sole trader's serious illness or death, then a "split" Trust could be the answer. Under such a Trust the benefit would be paid, via the Trustees,

- To the life assured if the occasion of payment is serious illness, and
- To the beneficiaries is the occasion of payment is death.

3.1.2 VitalityLife solution

The VitalityLife Plan effected on the life of a sole trader should be effected by the sole trader subject to our VitalityLife Discretionary Trust. Full details of this and its tax implications are included in our **Guide to the Discretionary Trust**.

Where the plan provides both Serious Illness and Life Cover then our Discretionary Trust can also be used as, under the Trust, the Life Cover benefits can be paid to the deceased's family/dependants and the Serious Illness benefit to the sole trader/life assured.

3.2 Partners

3.2.1 General

How to effect cover

The need for Key Person Cover is pretty much the same regardless of whether a business is a partnership or limited company. The big difference is how the cover can be put in place.

When the key person is an Owner and where the business is a partnership, the way that Key Person Cover is put in place has to take account of the fact that the partnership is not a separate legal entity. This means that, when partners are "key", the cover plan is normally implemented by the individual partner effecting a policy on their own life subject to a Partnership Trust.

Under this Trust the beneficiaries are all the partners for the time being in the business. In effect, the Plan, or its proceeds, belong to the business, rather than the individual partners. Each partner will be entitled to share in the proceeds in the same way as they share in the capital of the business.

A special separate guide is available for this Trust to which you should refer if the business is a partnership and there is a need for Key Person Cover on one or more but not all the partners.

The Partnership Trust should not be confused with the Business Trust.

Alternatively, if all the partners are key persons, and especially if they are effecting ownership protection cover, Key Person Cover can be effected by each partner effecting a policy subject to the Business Trust.

The policy proceeds would be paid to the Trustees to use for the benefit of the surviving or continuing partners. For example, in the ABC partnership, partner A dies or becomes seriously ill and the policy proceeds are paid to B + C who then introduce these funds by way of loan to the partnership. These funds, in effect, remain the assets of the lenders but are constituted as a debt rather than interest in a partnership.

Tax implications

There is no tax relief on the premiums but no tax on the sum assured.

If the policies are own life policies under a Business Trust – despite the fact that the settlor can benefit - as long as each partner does the same thing, there should be, in most cases, full commerciality and so no adverse IHT or CGT consequences. Whether this is so (and it usually would be in "arm's length" partnership agreements) would depend on the facts.

If the policies are under the Partnership Trust, there should also not be any IHT or CGT consequences, as the policy will be a business asset and, as such, belong to the partners for the time being in the business.

For a full explanation of the tax implications of the Partnership Trust see the separate guide provided by VitalityLife.

Scottish partnerships

Legally, Scottish partnerships are very different from English partnerships in that a Scottish partnership is a separate legal entity.

This means that the partners in a Scottish partnership have another option for solving the Key Person Cover need. They could, of course, use policies effected in the same way as English partners - that is, subject to Business Trusts. Alternatively, the partnership could itself effect (ie. separately contract for) policies on the lives of the "key" partners on a "life of another" basis. No Trust would be needed.

The tax effect would be the same though. The purpose of the policy would clearly be a capital one as the policies would be on the lives of "Owners" for the benefit of the Owners.

This means that there would be no tax relief on the premiums but the sum assured would not be assessable.

3.2.2 VitalityLife solution

The arrangement described above can be implemented either:

- by each partner taking part in the arrangement effecting a VitalityLife Business Protection Plan on their own life for the benefit of the other partners using the VitalityLife Business Trust, or
- by the Scottish Partnership effecting the Plan on a life of another basis without the need for a Trust.

3.3 LLP members

3.3.1 General

Key Person Cover can be provided for in a similar way as for partners ie. through own life Business Trust policies where the key persons are the members of the LLP.

However, in addition and because of its separate legal personality and contractual capacity, the LLP could, (in the same way as a Scottish partnership can), effect policies on a life of another basis to hold each policy as a business asset, without the need for a Trust.

Regardless of which of the above two methods is adopted, where the lives assured are the members of the LLP, there would be no tax relief on the premiums and no tax on the sums assured. Both transactions would, in effect, be considered to be capital transactions.

3.3.2 The VitalityLife solution

The arrangements described above can be implemented either:

- By each (key) member of the LLP effecting a VitalityLife Business Protection Plan on their own life subject to a Business Trust for the benefit of the other members, or
- By the LLP effecting Plans on the lives of the key members on a "life of another " basis – without the need for a Trust.

3.4 Company owners

3.4.1 General

How to effect cover

The fact that a company is a separate legal entity with contractual capacity is a very important factor to consider when setting up Key Person Cover and Ownership Protection Cover. For both, there are corporate and individual cover options.

Using the corporate route, the policy on the life of the key person would be effected by the company for its own benefit. No Trust will be needed.

An alternative means of providing Key Person Cover on the lives of the shareholding directors is for the individual directors to effect policies on their own lives subject to a Business Trust for the benefit of their co-shareholders – ie. in the same way as partners in a partnership. Which is best, will depend on the facts.

Taxation implications

The relative levels of corporate and personal taxation clearly have an impact on the net of tax cost of the personal and corporate methods of effecting cover.

Using the corporate route, the policy remains an asset on the balance sheet. Whether the receipt of the proceeds will be subject to tax will depend on the circumstances but, in most cases, if the purpose of the policy is a capital purpose and not a revenue purpose, and especially given that tax relief on the premiums will generally not be available when the policy is on the life of a shareholder, the policy proceeds should not be taxable.

For the general rules on when tax relief can be available (and the assessability of the sum assured) under Key Person Cover policies see section **3.5 below**.

Using the personal route, on the death or serious illness of the life assured the sum assured will be paid IHT free under the Trust to the continuing Owners who can then lend these funds to their company. This would create or enhance their loan/capital accounts with the company.

Using the personal route may seem attractively flexible. However, the cost of providing the cover in this way after taking account of the tax aspects is usually higher.

This is because, in effect, the cost of the premiums will have to be met (one way or another) out of after-tax (and, where relevant, NICs) income. A high proportion of shareholding directors are likely to have a marginal rate of tax that is higher (possibly significantly higher) than the rate of tax paid by the company on its profits.

If you add the National Insurance cost to that then the margin of difference can be quite high. It is worth noting that even if the company pays the premiums under personal Trust policies proposed for by the shareholding directors this will amount to "meeting a pecuniary liability" of the director and both tax and NICs will be due.

To leave the directors' net position unaffected by the premium payments, the company would then need to pay the premiums, any employer's NICs and sufficient additional salary such that after tax and any NICs on it the Owner had enough to meet the extra tax/NICs on the premiums.

It would be possible to avoid the employer NICs if the shareholding director received the payment from the company to meet the premium cost by way of dividend.

3.4.2 VitalityLife solution

A VitalityLife Business Protection Plan can be effected by a company on the life of the Owner or an employee. No Trust is required.

Alternatively, where the cover is on the life of shareholding director, and especially where the shareholders are also entering into Ownership Protection/share purchase arrangements, individual Plans can be effected subject to the VitalityLife Business Trust, in the same way as amongst the partners. As explained above, though, while this route offers some flexibility it is also likely to be more costly after tax is taken into account.

3.5 Employees

3.5.1 General

In most cases, where the key person is an employee (who is not also an Owner), regardless of who the employer is (ie. a company, partnership, LLP or a sole trader) the cover on the life of the employee will be founded on a life of another policy on the life of that employee. This is true for both death and serious illness cover. The policy will be held on the balance sheet and for most businesses this will be the "natural" most straightforward solution.

Where the business is a company the company will be the proposer and the policyholder. No Trust will be needed.

For a partnership, it will be usual for either all the partners to effect the policy, in which case no Trust will be necessary; or for one or more partners to effect the policy subject to a special Partnership Trust to hold the policy for all the partners for the time being.

Tax implications

The tax implications of this solution haven't changed since the relatively well known "Anderson" rules were first articulated in 1944. According to these (and the official guidance and commentary that has followed since), the tax deductibility of the premiums will be determined by reference to the relationship between the employer and the life assured, the type of policy, its purpose and the reasonableness of the sum assured.

In relation to the policy, the term should be appropriate to the duration of the risk. The sum assured should be "reasonable" (in other words, justifiable) in relation to the risk. The purpose of the cover must be a revenue purpose as opposed to a capital one. This means that premiums under loan cover plans cannot qualify for deductibility.

So how about the relationship between the employer and the life assured? For the premium to be deductible it is essential that neither the life assured nor their family should hold a major shareholding in the company. The rationale behind this is that when the company pays premiums under a policy on the life of such a person it is effectively laying out money for the shareholder's own benefit.In its general guidance on the "wholly and exclusively" test in section 74 ICTA 1988, HMRC states as follows:

"Circumstances in which there may be a non-trade purpose for taking out a "key person" policy are where the policy is in respect of directors who are major shareholders but not other employees."

As far as we are aware, HMRC has not commented on the meaning of "major" in this context.

It seems likely that a shareholding of 5% or less would be treated as not being major for this purpose but, no doubt, experience will vary between local Tax Inspectors. This position on any particular case should be confirmed by the relevant local Inspector.

Ultimately it will be the local Tax Inspector who will decide whether or not to allow the premiums as a deduction.

It is not possible to forego the tax deduction (assuming the premiums are eligible for deduction in the first place) to ensure the more favourable tax treatment of the policy proceeds.

Where an employee is a shareholder it is imperative to obtain an advance indication as to how the premiums will be treated for tax purposes - in such a case it would be unwise to rely on premiums being deductible regardless of the policy type.

The local Tax Inspector should be asked to confirm the deductibility of the premiums but is unlikely to commit himself to stating how the proceeds will be taxed because he cannot bind their successors. However, generally speaking, if premiums are deductible it will normally follow that the proceeds are taxable, and if the premiums are not deductible the proceeds will normally not be taxable.

Where the proceeds are likely to be assessable then the sum assured under the policy should itself be increased so that there is sufficient to meet the tax as well as provide the required amount.

In connection with the assessment or tax freedom of the proceeds of a corporate Key Person Cover policy it is important to note that, generally speaking, it is the proven purpose of the policy when the contract is first entered into that will determine the tax treatment of the sum assured. This means that it is not necessary to continually test and retest the purpose of the cover when each premium is paid nor is what the sum assured is actually used for relevant to its tax treatment.

This is made clear in HMRC's Business Income Manual and the Greycon case which reaffirmed the absolute importance of the "original purpose" when determining the tax treatment of the sum assured. In this case, HMRC attempted unsuccessfully to assess the company on the proceeds of a Key Person Cover policy on the lives of shareholders under which the premiums had not been deductible. This was on the basis of what the funds were actually used for. However, the correct approach is to determine, based on the evidence, what the purpose was when the policies were **effected**.

The case was also helpful in reaffirming the validity of the "general rule" that if the premiums are non-deductible the sum assured should not be assessable.

3.5.2 VitalityLife solution

A VitalityLife Business Protection Plan can be effected on a life of another basis on the life of a key employee, by a sole trader, a company or the partners (as individuals).

In the case of a partnership, the Plan should be written subject to the Partnership Trust.

4. Owner Protection on death: needs and solutions for business owners

4.1 General

Owner Protection arrangements will involve only partners (including LLP members) or shareholders. Where there are equivalent arrangements for both we will refer to them as "Owners" for simplicity.

In most non-family businesses run by more than one person, it is generally recognised and accepted that, in the event of the death of an Owner, it will usually be more desirable for both the continuing Owners and the family of the deceased Owner that the surviving Owners retain control of the business whilst the family of the deceased Owner is compensated for their share of their business. This is normally effected by a sale and purchase of the deceased Owner's share in the business by the continuing Owners.

Depending on the type of business structure, different arrangements may be suitable.

Partners

In some partnerships, there may be an automatic accrual provision, ie. a provision for the share of the partner to automatically pass to the continuing or surviving partners. In such circumstances, separate financial provision for the retiring partner or the family of the deceased partner would usually be funded through life assurance and pensions on an individual basis, eg. a life assurance policy on the life of the owner held in a Discretionary Trust for their families. It is unusual to find this type of arrangement in trading businesses.

Companies

In some limited companies there may be provisions for the company itself to purchase the shares of the deceased shareholder.

While the articles of association certainly need to be checked for any coverage given to Ownership Protection, it is rare (though not impossible) that you would find anything specific. Standard articles are likely to contain what are usually known as "pre-emption" provisions but these usually deal with the priority rights of existing shareholders to subscribe for newly issued shares or to have "first refusal" on any sale of shares of an existing shareholder being contemplated. They are not likely to provide for effective compulsion to buy and sell through double or cross options. Each case will, of course, depend on its own facts though and there is no substitute for just finding out by reviewing what, if any, existing arrangements are in force.

Working with your client's accountant and solicitor in this "discovery" can produce a powerful and informed business outcome both in relation to the client under consideration and also in the context of the broader relationship between the adviser and the other professionals.

Company buying its own shares

As stated above, in certain circumstances a private company can purchase its own shares. If that happens, the shares that have been purchased are cancelled and the shareholdings of the remaining shareholders are proportionately increased. It is possible to fund for such purchase and this will be done by the company effecting a policy on the life of the relevant shareholder. No Trust would be needed and the policy will be on the company's balance sheet. Although premium payments under such policy would not be tax deductible, the net cost is likely to be less that where individual shareholders are funding policies themselves from after-tax earnings. Such an arrangement may therefore appeal because of the lower cost and the relative simplicity at the outset.

The main drawback of the "corporate" share purchase route is that if, say, the relevant shareholder dies or becomes seriously ill –and the purchase is to take place, there will be considerable amount of work involved as certain company law requirements must be complied with before a purchase can take place and further requirements need to be satisfied to ensure the desired tax treatment.

This route therefore cannot offer the certainty that the cross option arrangements between shareholders offer as there can be no certainty that the important legal pre-conditions to purchase could be satisfied.

In most cases of trading "non-family" businesses, therefore, an agreement for share purchase between the Owners (as opposed to a corporate share purchase) would be the preferred route. However, both routes should be discussed with the Owners.

For more details on the company share purchase see Section 9 of this Guide.

Cross options – providing for sale and purchase in specified circumstances

In most cases, for tax reasons, the agreement for purchase would be in the form of an option agreement between the Owners. Having options as opposed to a binding agreement is particularly relevant for agreements for purchase on death, as business property relief for inheritance tax purposes would not be precluded. If there is a binding agreement for sale, the business interest will be treated as cash in the estate of the deceased (taxable at up to 40%) rather than a business asset which can benefit from 100% relief from IHT. This would mean that business property relief would be denied.

Whilst IHT is less relevant to a purchase following a serious illness, in most cases it is sensible to have agreements for purchase on serious illness and on death in a similar form, (ie. non-binding) if only to ensure they are consistent and easily understood by all the parties.

The effect of a cross option agreement is that, although the agreement is not binding, if one party decides to exercise their option, the other party will be bound to join in the transaction. Thus, even though an agreement is expressed as an option agreement it provides, in practice, as much certainty as a binding agreement for sale. The only time the sale/purchase will not take place is if both parties do not wish to proceed.

Providing the funds to make the purchase

In order to provide funds for the purchase, it is generally accepted that such funds are usually best provided by an appropriate life assurance policy. To fund for purchase on death, ordinary life assurance will be appropriate. To fund for purchase on serious illness or disability, an appropriate policy providing such cover will be required.

In order to ensure that funds are available in the right hands, it is necessary to use an appropriate Trust. In business assurance arrangements only special Trusts should be used. Under such "Business Trusts", generally speaking, the surviving or continuing Owners will benefit from the policy proceeds, usually in the proportions in which they will be expected to effect the purchase. It is essential that all the beneficiaries under the Trust are parties to the purchase arrangement.

For LLPs, it's important to note that although a LLP is a separate legal person, an equivalent solution to "corporate share purchase" (as described above for limited companies) is not available to LLPs. Thus the solutions you would use for a partnership and the tax and legal consequences are all just as valid and relevant for LLPs.

4.2 VitalityLife solutions

The VitalityLife Business Protection Plan includes both Life Cover and Serious Illness Cover in one policy (if the Disability Cover for Business is included). VitalityLife also offer a Business Trust and a cross option agreement to help implement an arrangement for share purchase following the death of an Owner based on each Owner effecting a Plan on their life subject to a Business Trust for the primary benefit of the other Owners.

The option agreement is entered into on the premise that each Owner taking part in the arrangement has effected a VitalityLife Business Protection Plan which is made subject to the VitalityLife Business Trust for the benefit of the other Owners. The funds to make the purchase will then be provided by the VitalityLife policy held in Trust.

VitalityLife offers the following option agreements:

- A "standard" agreement for non-related business owners;
- An agreement which also deals with a share of the business of a non-working spouse; and
- An agreement to facilitate company purchase of the shares.

The Business Trust and the cross option agreement for purchase on death are fully described in **sections 6 and 7** of this guide.

5. Ownership protection on serious illness or disability: needs and solutions for business owners

5.1 General

It is generally acknowledged that serious challenges for a business and its Owners can also arise on the incapacity of an Owner.

It is therefore generally recognised and accepted that in the event of the incapacity of an Owner which is totally disabling, when it is relatively clear that it will not be possible for the incapacitated Owner to return to running the business full time, (or in an "acceptable part-time role), it will usually be more desirable for both the continuing Owners and the incapacitated Owner that the continuing Owners retain control of the business whilst the incapacitated Owner is compensated for their share of the business. This is normally effected by a sale of the incapacitated Owner's share in the business and purchase by the continuing Owners.

As with the provisions on death, depending on the structure of the business, different solutions may be appropriate. In some partnerships, there may be a provision for the share of the partner to automatically accrue to the continuing partners with financial provision for the retiring partner being funded through a pension on an individual basis effectively funded as a first charge on profits. In some limited companies there may be provisions for the company itself to purchase the shares of the incapacitated shareholder.

In most cases of trading "non-family" businesses, however, there will (or should) be an agreement for share purchase between the Owners, in a similar way as for arrangements on death.

There is, of course, a fundamental difference between an arrangement for the purchase of a business interest on death and an arrangement for purchase following serious illness or disability.

This is because the degree of illness or disability will, in practice, dictate whether the seriously ill Owner wishes to dispose of his business interest. It is thus difficult, if not impossible, to pre-designate what will happen. Even where serious illness is diagnosed and a valid claim can be made under the policy funding the arrangement for share purchase, in view of the fact that a number of medical conditions covered by this type of policy may not be terminal or totally disabling, it is possible that after a period of convalescence the Owner will return to work.

In principle, three possibilities for dealing with this problem are available to the Owners:

(i) No agreement

It could be argued that, since all the parties will be alive at the time of any prospective purchase, there is no need for any advance agreement and any sale/purchase can simply be agreed at the time. The benefit of this approach is that there is no need to get involved with any documentation (to regulate the sale/purchase) at the time the policy is effected so the setting up of the cover is more straightforward. The downside, of course, is the risk that it will be difficult to reach an agreement at that time (where in an extreme situation the seriously ill Owner may be physically incapable of making a decision) and therefore there is no certainty as to what will happen. For this reason, some form of agreement would normally be recommended and this could take the form of a cross option agreement or single option agreement, as outlined below.

(ii) Cross (double) option agreement for sale/purchase on serious illness/disability

This would be based on the same principles as for a purchase on death and as outlined in **section 4.1**. In this case, there will be two corresponding options: the seriously ill Owner will have an option to sell and his co-Owners an option to buy. If either party exercises their option, the sale will go ahead. This, in effect, would mean that the continuing Owners would be able to force the seriously ill Owner to sell his business interest, perhaps even against his will. However, certainty will be provided as to what will happen in the event of an Owner becoming seriously ill or disabled. A sale and purchase will only not take place if both parties agree that it should not take place.

It is possible that such certainty may only be needed in certain circumstances which can be defined to ensure that an Owner is not forced to sell his business interest when he is still capable of continuing in the business but a claim has been made under a policy. Some certainty could be provided in certain circumstances, for example by carefully defining a particular condition, such as total or permanent disability, or making provision that a purchase will take place in the event of the Owner being unable to carry out their business activities through illness or disability covered by a serious illness policy for a period of, say, six months or more.

In such a case, effectively a forced retirement could be provided for, with the provision for the purchase by means of a cross option agreement. In essence, it will be necessary for the Owners to envisage what could possibly happen and cater for it while providing as much flexibility as is acceptable.

(iii) Single option agreement

In many cases the Owners will feel that to be able to force the seriously ill or disabled Owner to have to dispose of their business interest would be unfair and a fairer solution would be to place the seriously ill or disabled Owner in the "driving seat", so to speak, ie. to give him control over whether a sale of their business interest should be made or not made following their serious illness or disability. This will normally be provided by means of a single option agreement, that is the seriously ill Owner having the option to sell, with no corresponding option to buy given to the other Owners, ie. without the possibility of him being forced to sell, as could be the case with a cross option agreement.

5.2 VitalityLife solutions

VitalityLife offer a Business Trust and an option agreement to help implement an arrangement for purchase of a business interest following the incapacity of an Owner. The option agreement for purchase on serious illness or disability offers a choice of provisions – either a cross option or a single option agreement, depending on what is required.

Equivalent types of option agreement to those described in 4.2 for purchase on death (but giving a choice of single option or cross option as described above) are available for purchase on serious illness or disability.

The "standard" option agreement is entered into on the premise that each Owner taking part in the arrangement has effected a VitalityLife Business Protection Plan which is made subject to the VitalityLife Business Trust for the benefit of the other Owners. The funds to make the purchase will then be provided by the VitalityLife Business Protection Plan.

Separate drafts are provided where company share purchase is contemplated and for a situation where non-working spouses are involved.

The VitalityLife Business Trust and the option agreements are fully described in **sections 6, 7, 8 and 9** of this guide.

6. VitalityLife Business Trust in detail

6.1 Trust provisions

- The Business Trust is a flexible power of appointment (interest in possession) Trust.
- During the Trust period (up to 125 years under English or Scots law and 80 years under the law of Northern Ireland) the Trustees may appoint the Trust benefits to any of the Potential Beneficiaries. The Potential Beneficiaries under the Trust are any of the partners in, or members of, the firm or shareholders in the company. The Potential Beneficiaries include the life assured under the policy who is the Settlor.
- In default of appointment, the Default Beneficiaries will benefit. The Settlor may name the Default Beneficiaries and the shares in which they are to benefit. This will only be necessary if they are other than all the current co-Owners of the Settlor or if they are to benefit in proportions other than those in which they own the business between them. Normally the Default Beneficiaries would be all the current co-Owners of the Settlor and they would benefit in the same proportions as they own the business between them ignoring the Settlor's interest in the business (the "Share").
- If the Settlor leaves the business otherwise than following a serious illness or disability covered by the Plan, then the benefits of the policy will revert to the Settlor absolutely (as the Trust will then be redundant).
- To make sure that the arrangement has every chance of being seen to be a commercial arrangement and so there are no unwanted tax implications, no person other than the co-Owners involved in the business arrangement will be a beneficiary. There is a clause in the Trust which ensures that this will be so.
- The draft Trust offers a choice of applicable law depending on where the Settlor lives – this can be the law of England and Wales, law of Scotland or the law of Northern Ireland. The beneficial provisions of the Trust as well as the tax implications of the Trust are the same throughout the UK.

6.2 Legal and practical implications

The Trust is established by the applicant (the life assured) completing the Trust request form at the same time as applying for the Plan.

It is essential that the Trust is effected only at the time the Plan is applied for and not later, in order to avoid unwanted and potentially expensive capital gains tax implications.

This is because an assignment of an existing Plan to a Trust as part of a commercial arrangement between co-Owners could be treated as an assignment for actual consideration with the result that the Plan proceeds (less premiums paid) could be subject to capital gains tax under section 210 TCGA 1992.

Following the issue of the Plan, the life assured (the Settlor of the Trust) – who will be the initial Trustee of the Trust – should appoint additional Trustees. The additional Trustees would normally be their co-Owners taking part in the business protection arrangement. A separate draft deed of appointment of additional Trustees is provided by VitalityLife for the approval of the parties' legal advisers.

6.3 Tax implications

- Provided the arrangements between the Owners are entered into at arm's length, on a commercial basis (i.e. that no gifts are involved), there will be no adverse inheritance tax (IHT) implications. This means that there will be no tax implications in respect of the premium payments and that the benefits payable under the VitalityLife Business Protection Plan will be paid free of tax to the Trustees.
- There may, however, be IHT and/or capital gains tax (CGT) implications for the Settlor (or their legal personal representatives after their death) when he/they dispose of their Share to their co-Owners (who will have received the funds from the Trustees to pay for the Share). These implications will depend on the structure of the business and the price paid – see **sections 7.4.3 and 8.4.3** for more details.
- To ensure that the arrangement is on a commercial basis, only the individuals who enter into the business protection arrangements and each of whom effects a policy under a similar Trust can be beneficiaries under the Business Trust. It is also important that each individual contributes an amount to the overall cost of the premiums under the relevant policies that reflects the benefits that may be received under the Trusts. If there is a large disparity in premium payments in respect of the individual Owners' policies, a form of premium "equalisation" may be necessary to ensure that no element of gifting is involved. In effect, each Owner should pay a proportion of the total cost of the arrangement that is commensurate with the likely benefit they may receive.

- Once the benefits have been paid to the Trustees, then if they are not immediately paid out to the beneficiaries, they may be held by the Trustees, for example, in a bank account, pending a decision on how they should be used. In such circumstances any interest arising from such funds will belong to the Default Beneficiaries under the Trust, ie. the co-Owners of the life assured (Settlor). As such they will be subject to income tax on such interest whether they actually receive it or not.
- If funds are held by the Trustees for a longer period and are invested in other assets there may be income tax and, possibly, capital gains tax implications to consider. The Trustees should obtain suitable advice before making an investment and take the tax implications of the relevant investments into consideration at that time.
- Any capital payments from the Trust will not be taxed in the hands of the recipient beneficiaries, ie. the co-Owners, although in some cases an exit charge for inheritance tax (IHT) may be applied (see below).
- For IHT purposes the Trust is treated as "relevant property" which means that potential IHT charges may apply every 10 years and when payments are made out of the Trust. This is despite the fact that the premium payments will not be subject to IHT provided the arrangement is fully "commercial" (as explained above). The maximum charge could be 6% of the value of the Trust fund in excess of the nil rate band. The Plan itself will have no value unless the life assured is in poor health (this will be relevant at the ten-year anniversaries) or the benefit has been paid to the Trustees by VitalityLife following the death or serious illness of the life assured. In practice, it is not expected that in most cases any IHT charges will arise.
- As the Settlor is included as a Potential Beneficiary under the Business Trust there is a possibility of the income tax pre-owned assets tax (POAT) charges applying although, in practice, this is remote, given that in most cases the Plan will have no value and the POAT charges do not start to bite unless the benefit derived from the asset in question is more than £5,000 in a year (meaning that the value of the asset in question must be at least £200,000), including the value of any other benefits accruing to the same individual under the POAT rules. This would be unusual in connection with any pure protection policy with no surrender value, such as the VitalityLife Business Protection Plan.

6.4 Business Trust and Secondary Owners

In such circumstances share purchase under the draft agreement is contemplated only on the death or serious illness/disability of a Primary Owner. This means that funds will be required following the death or serious illness of such an individual. To fund the purchase it will be necessary for each Primary Owner to effect a VitalityLife Business Protection Plan subject to a Business Trust. Under each Primary Owner's Business Trust only the other Primary Owners will benefit as only the Primary Owners will be effecting the purchase.

There will be no Life Cover on the Secondary Owner and the Secondary Owner will not benefit from the trusts.

If on the death of a Primary Owner the Share of a Secondary Owner to whom they are married is also to be sold/purchased, the sum assured under the Plan on the life of the Primary Owner must be sufficient to fund the purchase of the Shares of both the Primary Owner and the Secondary Owner.

Under the terms of the VitalityLife Business Trust, in order to preserve commerciality, a business owner cannot benefit under the trust of another unless he or she has also effected a Plan in trust for their co-owners. This is one of the reasons why the non-working spouses are excluded from all benefit and will not be participating in the purchase of any shares on the death of the other co-owners.

7. VitalityLife draft cross option agreements for purchase on death in detail

7.1 Provisions – standard agreement

The VitalityLife standard draft cross option agreement in relation to ownership protection on death provides that, in the event of the death of any party to the agreement (being a partner, member or shareholder in the business – "an Owner"), the legal personal representatives of the deceased Owner will have an option to sell their business interest (being a share in a partnership, interest in a LLP or a shareholding in a limited company and referred to as the Share") to the remaining Owners and the surviving Owners will have a corresponding option to buy.

As long as one of the parties exercise their option, the other will be bound and the sale/ purchase will go ahead.

If there is more than one continuing Owner, the Share of the deceased Owner will be bought in such proportions as the other Owners own the business between them, ignoring the Share of the deceased Owner. For example, if there are three Owners owning equal Shares, and one of them dies, and the relevant option is exercised, the remaining two will be required to purchase the deceased Owner's Share equally ie. 50/50.

The agreement specifies that each party must have effected a VitalityLife Business Protection Plan subject to a Business Trust for the benefit of the other Owners.

The agreement also makes provision for what should happen if the benefit payable under the Plan is less than the agreed value of the Share.

Other relevant provisions

- The time limits for 'sell' and 'buy' options are six months and three months from the date of death respectively (or one month after probate is granted if later).
- The parties buying the Share will be buying in the proportions in which they own the business (ignoring the Share of the deceased).
- The agreement includes the basis for setting the price at which the Share is to be purchased. The Parties can specify the value of each Share and such Specified Value can be valid for one year. If no value is stated, or any stated value is not reviewed every year, the fair market value will apply. The tax implications of specifying the value of the Share are considered in **section 7.2**.
- The agreement also deals with funding the purchase through appropriate life assurance policies (VitalityLife Business Protection Plans) and makes a provision for when the benefit payable under the Plan is less.
- The agreement is subject to the overriding authority of the constituent documents of the business, ie. the Articles and Memorandum or the Partnership/Membership Agreement, as appropriate.

In summary, the draft agreement is comprehensive and provides, through the Specified Value provision, the ability to deliver relative certainty coupled with flexibility through regular review.

7.2 Price and valuation

It is, of course, impossible to predetermine the exact value of a Share at the time of death of the Owner. However, most would agree that in an ideal world the level of funding for possible purchase of a Share should be such as to reflect its real value as closely as possible.

Under the VitalityLife draft cross option agreement the Owners can provide that the price to be paid should be the fair (open) market value of the
Share being bought at the time of purchase. In practice, it would then require an independent auditor or professional valuer to arrive at such a value. Clearly, however, some value will have to be agreed at the time the arrangement is entered into, if only to provide guidance on the necessary level of cover under the VitalityLife Plan.

It is usually recommended that each Plan is effected for the value which reflects the value of the Share of the life assured. However, the challenge is to determine **what** that value will be.

Specified Values

So as to provide clients with the option to secure greater clarity over what should be paid for an Owner's Share it is possible under the VitalityLife draft cross option agreement to specify the value of each Owner's Share in the draft agreement.

If such a Specified Value provision is adopted it is understood that there will be no adverse tax implications of such a pre-determination as long as it is arrived at on a commercial basis, the parties are independently advised, are of similar age and state of health, their Shares are of similar value and those values are regularly reviewed to ensure that they reflect commercial reality. In other circumstances there may be potential IHT and CGT implications – these are explained in **section 7.3** (on entering agreements) and in **section 7.4.3** (actual sale) below. Thus, it is important that the Specified Value approach is only considered where all of the stated criteria in relation to age, state of health, value, advice and review can be satisfied. All of this must be discussed with professional advisers before any action is taken or refrained from.

It is recommended, and the draft so provides, that the Specified Value is reviewed (but obviously changed only when appropriate) once a year. The draft cross option agreement provides that if the value is not so reviewed and either restated or amended by adding a memorandum to the option agreement, then the price under the option agreement will revert to the market value.

Given that in some circumstances there may be (potentially adverse) tax implications resulting from the use of Specified Values (both at the time of entering the option agreement and at the time of any actual sale/purchase) the following approach is recommended:

- Because of the possible tax implications (as outlined above), if the Specified Values provisions are adopted the parties should take specific independent advice before signing up to the agreement. This advice should relate specifically to what the value of the business and the Owner's Share is thought to be worth by such an independent expert.
- Generally speaking, the Specified Value provisions are only likely to be appropriate for use where the parties to the agreement are of equivalent age and state of health, all have similar Shares in the business and the Specified Value agreed is as close as possible to the market value of the relevant Shares.
- The possibility of the potential for a gain or a loss to be made by the selling party after the death of an Owner in circumstance where the value of the Share was not ascertained for inheritance tax purposes (because the spouse exemption or 100% business property relief applied) needs to be made clear to the parties. (See below for details).

7.3 The tax implications of entering into the agreement

Although, strictly speaking, a grant of an option is a disposal for capital gains tax (CGT) purposes, there are no tax implications for the parties entering into the option agreement if the purchase is to take place at market value.

If a Specified Value is chosen, then again, as long as it is agreed on a commercial basis, ie. the value reflects the commercial reality (the value of the Share at the time) and the owners are broadly speaking of similar age and in good health and independent advice has been taken, there will be no immediate tax implications.

In more detail

(i) There should be no adverse IHT implications for the parties entering into the agreement. The following should, however, be noted:

- Although in some cases the parties will be connected within the meaning of section 286 TCGA 1992 (e.g. partners), the intention is that in all cases the parties should be dealing with each other on an arm's length basis.
- Ideally the parties should be independently advised and ensure that they secure an independent valuation of their Share where a Specified Value provision is used so as to be able to demonstrate that the transaction was at arm's length so that no IHT consequences arise in relation to the grant of the option.

(ii) Although, strictly, a disposal for CGT purposes occurs when an option is granted, where the options are for purchase at market value then both the options would have little or no value and so there will be no immediate CGT implications for either party as a result of entering into the agreement.

(iii) Where the options are for the purchase of an Owner's Share at a Specified Value then, as long as:

- the Specified Value reflects the commercial value at the time the options were entered into,
- the parties are relatively young and healthy (so that the likelihood of the options being exercised is low), and
- the fixed period for the Specified Value is one year, the value of the options will also be negligible and so there should be no immediate CGT implications for either party as a result of entering into the agreement.

7.4 Agreements where non-working spouses are involved

In the drafts the term "Primary Owner" is used to describe a working Owner and the term "Secondary Owner" is used to describe the spouse or civil partner of a Primary Owner who owns a Share but is not involved in the running of the business.

The option agreement on death is similar to the "standard" option agreement on death described in sections 7.1 to 7.3 above except that it provides that the Shares of both the Primary Owner and the Secondary Owner will be bought/sold in the event of death of the Primary Owner. The purchase will only be made by the other Primary Owners.

7.5 Share purchase following death in practice

7.5.1 Making a claim

The Trustees, as the legal owners of the Plan, will make any claim under the VitalityLife Business Protection Plan.

They will need to submit the death certificate and the Trust deed and any deeds of appointment/retirement of Trustees as their proof of title.

Following the successful claim VitalityLife will pay the benefit to the Trustees.

7.5.2 The Trustees' role

The Trustees will hold the funds for the benefit of the beneficiaries under the Trust. In determining the distribution or other use of the Trust funds the purpose of the Plan will be paramount. If the purpose of the Plan was to provide funds only for Share purchase, then what will happen to the funds will depend on whether the surviving Owners exercise their option to buy or the legal personal representatives of the deceased Owner exercise their option to sell – or both.
Unless the option is exercised by one or both parties, the Trustees will have to wait until the option period (maximum six months) elapses before they can distribute the funds or use them for other purposes.

If the option to buy or sell is exercised, the Trustees should distribute the proceeds to the other Owners who are the Trust beneficiaries in such proportions as they will be effecting the purchase.

If the option is not exercised and the option period elapses, the Trustees will be free to use the funds for the benefit of any of the surviving Owners (as the beneficiaries of the Trust), in any way they wish.

If the Plan proceeds are paid into a bank account pending the decision as to what to do with the money and interest arises on the account, it will be taxed as the income of the Default Beneficiaries (normally the co-Owners of the deceased Owner). The Trustees should normally pay over such interest to those Owners.

7.5.3 Tax consequences of the sale

Following the death of an Owner their Share would be included in their estate and pass in accordance with their Will provisions (or intestacy if there is no valid Will). However, if an option to buy or sell is exercised (see below), the legal personal representatives of the deceased (LPRs), ie. executors or administrators, will be obliged to sell the Share so that the proceeds of the Share will pass to the beneficiary or beneficiaries under the Will of the deceased.

It is expected that in most cases the Share will qualify for 100% business property relief and so no IHT would be payable.

The exercise of the option to sell by the personal representatives of the deceased Owner or the option to purchase by the surviving Owners, would result in the sale of the deceased's Share to the surviving Owners.

A sale of a Share is a disposal for CGT purposes. The usual capital gains tax rules will apply. However, the Share would have been revalued on death so, as long as the sale is at a price equal to or close to the value at death, there will be no (or no significant) CGT or IHT implications.

In more detail

On the death of a party to the agreement (the agreement still being in force):

- On the basis that the parties entered into the agreement on terms that one would expect to see in an arm's length transaction (so that no transfer of value occurred when the agreement was made), the value of the deceased's Share for IHT will be determined by reference to the valuation clause specified in the agreement;
- The deceased's Share will be revalued for CGT on death and, so long as the value of the Share is ascertained for IHT, the IHT value will also be the value for CGT purposes on death; but
- Where the value is not ascertained for IHT (ie. because the Share either passes to a spouse as an exempt transfer or business property relief applies at 100%), the value for CGT will be the market value at the date of death.

On sale under the terms of the agreement (after the Owner's death):

- The CGT base cost for the sale of the Share will be the agreed value for IHT (ie. Specified Value if the value is ascertained) or the market value – depending on whether the value of the Share was ascertained for IHT (see above).
- There will be no gain for CGT if the disposal price is the same as the base cost. If the value of the Share were not "ascertained" for IHT (ie. because it was left to a spouse or was subject to 100% business property relief) then either a gain or a loss could arise for CGT purposes for the disposing legal personal representatives.

For arrangements involving Shares of non-working spouses the position is as follows:

The tax consequences of the purchase of the deceased Primary Owner's Share will be similar to those under a standard agreement dealt within 7.5.3 above.

On the sale of the Share of the surviving Secondary Owner during their lifetime the normal CGT rules will apply, namely that capital gains tax may be payable on so much of the gain as exceeds the Secondary Owner's available annual exemption. The disposal may, of course, qualify for entrepreneurs' relief to reduce the rate of tax payable.

8. VitalityLife draft option agreements for share purchase on serious illness or disability – in detail

8.1 The standard draft option agreement: choice of single or cross option

The draft option agreement gives the Owners a choice of provisions: the Owners can choose either:

- A cross option agreement, ie. with both sides having respective options to buy and sell in the event of an Owner becoming seriously ill or disabled and such event being covered by the VitalityLife Business Protection Plan, or
- A single option agreement where, in the event of an Owner becoming seriously ill or disabled and such event being covered by the VitalityLife Business Protection Plan, then only the seriously ill or disabled Owner will have an option to sell their Share to co-Owners.

The serious illness or disability that is covered under the Disability Cover for Business under the VitalityLife Business Protection Plan is referred to as **"incapacity"** in the draft option agreement.

Under the cross option agreement, if either side exercises their option, the purchase will take place – in effect the other Owners can force the incapacitated Owner out of business or the incapacitated Owner can force a purchase.

Under the single option agreement only the incapacitated Owner has an option to sell their Share, and cannot be forced to sell. **You must discuss the choice of the agreement between all the Owners and take guidance from your financial adviser before deciding which is suitable in your circumstances.**

Other relevant provisions

The time limits for 'sell' and 'buy' options (the latter only if the cross option basis is chosen) are twelve months and six months from the date of payment of the benefit under the policy respectively.

The remaining provisions are similar to those included in the cross option agreement on death – **see section 7.1** in this guide.

8.2 Price and valuation

As with the valuation issues relevant to the option agreement for the purchase on death, it is possible for the Owners to provide in the option agreement that the price to be paid should be the fair (open) market value of the Share being bought at the time of purchase.

Alternatively, the Owners may specify the value of each Owner's Share in the draft agreement – see **section 7.2** for the implications of each route. Obviously, if the owners are making arrangements for the purchase on death or earlier serious illness or disability, both agreements should have the same provisions as to the valuation.

The potential IHT and CGT implications of using a Specified Value in agreements for purchase on serious illness or disability are explained in **sections 8.3** (on entering agreements) and in **section 8.4.3** (actual sale).

8.3 Tax consequences of entering into the option agreement

Although, strictly speaking, a grant of an option is a disposal for capital gains tax (CGT) purposes, there are no tax implications for the parties entering into the option agreement if the purchase is to take place at market value. If Specified Value is chosen, then again, as long as it is done on a commercial basis, ie. the value reflects the commercial reality and the owners are broadly speaking of similar age and in good health, there will be no immediate tax implications.

In more detail

(i) There should be no adverse IHT implications for the parties entering into the agreement (regardless of whether there is a single option or cross options). The following should, however, be noted:

- although in some case the parties will be connected within the meaning of section 286 TCGA 1992 (e.g. partners), in all cases the parties should be dealing with each other on an arm's length basis.
- ideally the parties should be independently advised and ensure that they secure an independent valuation of each Share where the Specified Value basis is used so as to be able to demonstrate that the transaction was at arm's length so that no IHT consequences arise in relation to the grant of the option.

(ii) While strictly a disposal for CGT purposes occurs when an option is granted, where all the options are for a purchase at market value then all the options would have little or no value and so there will be no immediate CGT implications for either party as a result of entering into the agreement.

(iii) Where the options are for a purchase at a Specified Value then, as long as the Specified Value reflects the commercial value at the time the options were entered into and the parties are relatively young and healthy (so that the likelihood of the options being exercised is low) and the option period is for the specified one year, the value of the options will also be negligible and so there should be no immediate CGT implications for either party as a result of entering into the agreement.

8.4 Agreements where non-working spouses are involved

The option agreement for purchase of Shares on serious illness or disability of a Primary Owner is also similar to the "standard" agreement for purchase on serious illness described in sections 8.1 to 8.3 above, except that it deals with the sale/purchase of the Shares of both the Primary Owner and Secondary Owner (see section 7.4 above for an explanation of these terms) following serious illness or disability of the Primary Owner. The purchase will only be made by the other Primary Owners.

8.5.1 Making a claim

The Trustees, as the legal owners of the Plan, will make any claim under the VitalityLife Plan but medical details (and possibly an examination) will be required from the incapacitated life assured (ie. Owner). Thus it is expected that the parties will need to co-operate. In most cases the incapacitated Owner will still be one of the Trustees.

The claim must be made within 6 months of the event giving rise to the claim. Following the successful claim VitalityLife will pay the benefit to the Trustees.

8.5.2 The Trustees' role

The Trustees will hold the funds for the benefit of the beneficiaries. The purpose of the Plan will be paramount. If the purpose of the Plan was to provide funds only for Share purchase, then what will happen to the funds will depend on whether the incapacitated Owner exercises his option to sell, or where a cross option was initially chosen by the parties, the continuing Owners exercise their option to buy. Unless the option is exercised, the Trustees will have to wait until the option period (12 months) elapses before they can distribute the funds or use them for other purposes.

If the option to sell is exercised, the Trustees should distribute the proceeds to the other Owners, who are the Trust beneficiaries, in such proportions as they will be effecting the purchase.

If the option is not exercised and the option period elapses, the Trustees will be free to use the funds for the benefit of any of the Owners (as the beneficiaries of the Trust), including the incapacitated owner, in any way they wish.

If the Plan proceeds are paid into a bank account pending the decision as to what to do with the money and interest arises on the account, it will be taxed as the income of the Default Beneficiaries (normally the co-Owners of the incapacitated owner). The Trustees should normally pay over such interest to those Owners.

8.5.3 Tax consequences of the sale

The exercise of the option to sell by the incapacitated owner – or the option to purchase by the other Owners if the parties had chosen the cross option provisions - would result in the sale of the incapacitated Owner's Share.

A sale of a Share is a disposal for CGT purposes. The usual capital gains tax rules will apply. In particular, entrepreneurs' relief may be available subject to the usual conditions.

The capital gains tax implications will also depend on the structure of the business, ie. whether it is run as a partnership or a company and whether the purchase is at the Specified Value or market value.

If the shares of a Secondary Owner are also being sold (see 8.4 above) the tax consequences will be the same for both owners.

Partners and members of an LLP (both referred to as "partners" below)

For CGT purposes the partners are "**connected persons**" which means that even if the sale is at a price specified in the option agreement the incapacitated partner/seller will be treated as having received the open **market value**. This means that when the open market value exceeds the Specified Value the CGT liability will be on a gain greater than that which the selling partner has actually made. The reverse would be true if the open market value were lower than the Specified Value. For partners, therefore, it is particularly important that any Specified Values reflect commercial reality.

Shareholders

Where the incapacitated seller is a shareholder in a company but not in any way connected with the buyer (eg. by virtue of close family relationship or because an individual buyer and the seller were acting together to control the company) then the disposal price for calculating the capital gain will usually be that which is actually received. This will be the value stated in the agreement (eg. the Specified Value).

It should be borne in mind that whether or not a seller and buyer are connected is a relatively complex area and professional advice should be sought particularly with regard to the relevance or otherwise of section 286(7)TCGA 1992.

If the seller is connected in any way to the buyer (eg. by virtue of close family relationship) then even though they may receive the value specified in the agreement for the shares, for capital gains tax purposes he may be treated as having received the open market value. Where the open market value exceeds the Specified Value this will mean that their capital gains tax liability will be on a gain greater than that which he has actually made.

There should be no inheritance tax implications provided the arrangement is commercial.

In summary

- On the sale of a Share following the exercise of an option, if the buyer and seller are connected, the gain will be calculated by reference to the open market value at the time of the sale, (even if the Specified Value is included in the agreement and the Specified Value is paid). Where the parties are not connected and the Specified Value is used, that value will be used in the calculation of the gain ie. the value that is actually paid.
- Where the business is a trading business, then subject to satisfying the usual conditions, entrepreneurs' relief should be available and this will not be affected by the existence of the option agreement.

9. Company share purchase – special considerations

9.1 How does company share purchase using an option agreement on death or on serious illness/ disability work?

A limited company and one of its shareholders enter an agreement which provides that if the shareholder were to die, the company would have the option to buy the deceased's shares in the company and the personal representatives of the deceased shareholder would have the option to sell the deceased's shares back to the company.

The key provisions of the option agreement and the mechanics of the arrangement are similar to those described in section 7 above in connection with option agreements between business Owners.

There is an equivalent draft agreement for purchase on serious illness/disability between a company and the shareholder. As with the "standard" option agreement described in section 8 above, that is a choice of cross option or single option.

9.2 Legal requirements that need to be satisfied before a company can buy its own shares

The following are the main requirements under the Companies Act 2006.

- The Company's Articles of Association should not restrict or prohibit a purchase of its own shares.
- The share purchase must not leave the company with only redeemable and/or treasury shares.
- A private company must use distributable profits to purchase the shares before it can resort to capital.

Additional safeguards are required where the purchase is to be made out of capital. All these matters must be discussed with the Owner's advisers before deciding whether company share purchase is suitable.

There are also specific requirements to be satisfied at the time of the purchase, including time limits within which the share purchase must take place.

Various statutory forms must be completed and delivered to the Registrar of Companies.

Copies of the contract must be available for inspection for a period of 10 years after completion of the contract.

It is important to remember that the shares purchased must be fully paid up and the consideration for the shares must be paid by the company immediately in money ie. payment by instalments is not possible.

Following the share purchase, the shares purchased by the company must be cancelled, thus reducing the issued share capital.

Professional advice will also be necessary at the time of purchase to ensure compliance with all the legal requirements.

9.3 Funding the company purchase of the shares

It is expected that the company will effect a VitalityLife Business Protection Plan on the life of the shareholder. The company must have the power to effect any life policy and sufficient insurable interest in the person on whose life the policy is effected (normally both would exist).

As previously explained, with this route, because of the need to satisfy the various legal requirements, there can be no guarantee that the company will be able to use the proceeds of the policy to buy the shares of the deceased shareholder following the shareholder's death.

There is a requirement that the directors must be able to give a (justifiable) statement of solvency as one of the conditions of company share purchase. In addition, there is a requirement to publicise the intended purchase. So if a company has substantial debts, the directors may not be able to provide the required solvency statement. In addition, the company's creditors may object to the company capital being spent on share purchase if this could, in their view, prejudice their interests.

Therefore there can be no absolute guarantee on this.

9.4 The tax consequences of an option agreement involving a company

The tax implications of an option agreement will be broadly similar to those involving "standard" option agreements between Owners as described in sections 7 and 8 above.

The tax implications of the actual share purchase are more complex.

When the company makes a payment in return for the shares, there are two possibilities: the payment may be treated as a capital payment subject to potential capital gains tax in the hands of the vendor; or as a distribution from a company which would be subject to income tax. Clearly, the preferred option is capital treatment and this treatment can be confirmed by the parties obtaining clearance from HMRC before the purchase takes place. There are special conditions to be satisfied for "capital treatment" to apply.

Different provisions apply in two circumstances; firstly, in what is called a "general transaction" - where the purchase is for the benefit of the company's trade - and, secondly, where the sale is "necessary to meet an inheritance tax liability" on the shareholder's death. In addition, the following conditions are common to both sets of circumstances:

- The company must be unquoted (this includes companies whose shares are dealt on the Alternative Investment Market (AIM).
- The company must be a trading company (not an investment company).

The additional conditions to be satisfied for general transactions are, broadly speaking:-

- The purchase is made wholly or mainly for the purpose of benefiting the trade carried on by the company.
- The transaction should not be part of a scheme or arrangement made to avoid tax.
- The vendor must be resident and ordinarily resident in the UK.
- The vendor should have been the beneficial owner of the shares for at least five years immediately preceding the sale (reduced to 3 years if the shares are inherited).
- The vendor's shareholding must be substantially reduced, i.e. by more than 25%, and after the sale the vendor must not be connected with the company.

Where the proceeds of the purchase are required to meet an inheritance tax liability on death, the conditions are as follows:-

- The company must be an unquoted trading company,
- The whole, or substantially the whole, of the payment received by the personal representatives must be used to satisfy the inheritance tax payable on death.
- Capital treatment on the sale will be allowed to the extent that the inheritance tax liability could not be satisfied without undue hardship.

If the above conditions are not satisfied, distribution treatment will apply, which means the gain on the sale will be subject to income tax.

On the basis that the purchase is treated as a capital transaction if the sale follows the death of the shareholder the shares will be revalued on death for CGT purposes (meaning that little or no gain would arise on a sale made relatively soon after death).

For a purchase following serious illness, entrepreneurs relief will usually apply - see section 8.5.3 above.

It is reiterated that at the time of the share purchase professional advice will be essential to ensure that the desired consequences are achieved, both in respect of the procedural requirements and the tax treatment.

FIND OUT MORE

To find out more about our Business Protection Plan or any other products, please speak to your financial adviser or take a look at **vitality.co.uk**

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