SHAREHOLDER PROTECTION (TERM ASSURANCE AND/OR CRITICAL ILLNESS)

What is it?

As you are aware, if one of the shareholders were to die, their share of the business would pass according to either the terms of their will or the laws of intestacy (as appropriate) which could cause difficulties if the recipient of the shares had no interest in the business and wanted to sell the shares to a third party.

The simplest way to provide for such an eventuality is for each shareholder to take out a life policy on their own life and write it in trust for the benefit of the remaining shareholders.

The cross option agreement is a formal agreement between business owners which deals with what may happen to their share of the firm on their death or on them becoming terminally or critically ill. The agreement may include a double or a single option, or sometimes both.

Under a single option agreement only one of the parties to the agreement has the right to exercise an option whilst under a double option agreement either party has the right to exercise an option. In either scenario, once an option has been exercised, the agreement becomes binding.

Why use a cross option agreement?

Business Relief (BR) is a relief against inheritance tax, covering a business or interest in a business and will often mean that no inheritance tax is payable. If a binding contract for sale of the business property exists at the date of transfer (i.e. on death) BR is lost. Under a cross option agreement, the contract for sale does not become binding until a later date and only if either party chooses to exercise the option, thus preserving the relief.

As the tax treatment of each case is considered on its own merits by HM Revenue & Customs the business should confirm the tax position with its own Inspector of Taxes prior to taking out a policy.

Where a Critical Illness benefit is included, a single option agreement should be incorporated in respect of this situation. This will provide the option for the shareholder suffering from the critical illness to sell his/her share of the company in the event of a valid claim being made. However, the remaining shareholders do not have an option to purchase the share should the 'ill' partner not wish to sell – hence, 'single' option agreement.

Term assurance

A level term assurance policy provides for a capital amount (the sum assured) to be paid out in the event of the death of the life assured within a specified term assuming that premiums have been paid when due up to the date of death.

Critical illness cover

In the event that a life assured suffers a critical illness then the sum assured under the contract will become payable. Once this sum assured has been paid the life cover will/will not remain in force. Definitions of a critical illness vary between different insurers and you can find a list of which illnesses are covered within the Key Features Document.

A Critical Illness plan is designed to pay out a lump sum if you are diagnosed as suffering from any of the specified critical illnesses but survive for a period of time after diagnosis (normally 28 days). The lump sum could be used to pay for things like nursing care, home help, adapting your house to accommodate a disability, paying off a mortgage or for a holiday to recover from treatment.

Critical illnesses usually include cancer, coronary artery bypass, heart attack, kidney failure, multiple sclerosis, major organ transplant and stroke. These are known as core conditions and account for the majority of claims. The comprehensiveness of conditions covered by different critical illness policies varies enormously and details of which conditions are/are not covered by the policy we are recommending will be fully explained in any supporting literature which you should check to ensure it meets your purposes.

It is usual to include cover for permanent total disability within the contract. The definition of Permanent Total Disability does vary and some insurers define it as the life assured being unable to follow his/her normal occupation as a result of sickness or accident whilst others will define it as the life assured being unable to independently perform a specified number of Activities of Daily Living (such as dressing or feeding) as a result of sickness or accident.

Writing this policy under trust

It is usual for the policy to be set up under a trust. A trust can be especially designed for use in conjunction with shareholder protection arrangements and can incorporate some important areas of flexibility.

The beneficiaries will include anyone who is a shareholder in the company in the proportions in which they own shares. A trust can allow for departing shareholders to be removed from the trust automatically and new shareholders to be added, and can also provide for changes in shareholding proportions.

In the event that you cease to be associated with the company, the policy would revert to you.

Using a trust provides a number of benefits, specifically:

- You can identify who the beneficiaries should be (and with some trusts you have the ability to change this).
- Your chosen beneficiaries will receive the benefit quickly without the need for probate or prior payment of inheritance tax. For this to be effective, it is essential that you appoint at least one additional trustee to act with you and, of course, to deal with the policy in the event of your death.
- The amounts payable to your beneficiaries are, generally, free from inheritance tax.

Eligibility

The minimum age to take out a life assurance contract is 18.

Taxation

Tax relief will not be available to you in respect of premium payments, however no tax would be payable on the proceeds of the plan.

If the firm makes the premium payments on behalf of a shareholder, the individual will pay income tax on the amount of the premium payments as additional salary. The firm will pay national insurance and will receive tax relief on the premium payments as they are treated in the same way as salary and would be a tax deductible expense.

All statements concerning the tax treatment of products and their benefits are based on our understanding of current tax law and HM Revenue and Customs' practice. Levels and bases of tax relief are subject to change.

Inheritance tax

Provided HMRC accepts that a business protection arrangement is purely commercial, the premiums should be exempt transfers for Inheritance Tax purposes.

What may affect commerciality?

The individual facts of each case will determine whether it is commercial and the following factors will support an arrangement being classed as commercial:

- All the shareholders will normally be expected to take part in the arrangement
- New shareholders should be included as appropriate
- Correct and legally binding agreements should be in place
- The amounts covered by life policies should be the individuals' full interests
- The beneficiaries of the business protection trust should be restricted to the settlor and other 'owners', for the time being in the business

Risk considerations

There are a number of risk considerations that need to be taken into account. It is important that you are aware of these.

- This contract is designed to provide you with a high level of cover at minimal cost and therefore does not acquire a surrender value at any time
- If for any reason you stop paying premiums, cover will cease
- Failure to disclose any requested or relevant information may adversely affect any future claims
- Payment will not be made for a critical illness claim arising from an excluded condition. (For Critical Illness only)
- At the end of the term selected, cover will cease and no further benefit will be payable
- You may wish to refer to your other professional advisers such as solicitors and accountants before or after implementing this type of plan to ensure that it matches your corporate objectives
- The present tax free treatment of the policy benefits may change
- If any relevant information provided, when applying, is not disclosed accurately and honestly, this could result in any cover offered becoming invalid and/or may result in the non-payment of any future claims
- If this policy is to replace any existing policy offering the same type / level of cover, you must not cancel any existing policy until the new policy is in force