Next generation planning for the owner-managed company.

What happens if one shareholder dies and how can the dead shareholder's shares be funded and paid for by the surviving shareholder without crippling the company? This is called next generation planning for the owner-managed company.

<u>Key-man insurance</u>

This insurance is to be taken out by the Company. The Company will obtain tax relief for the premiums, and policy proceeds will be taxed in the Company's hands.

Key Man insurance covers the death of long-term disablement of a key player in the Company. Replacing the key player at no notice in a crisis is likely to cost a lot of money to obtain the right replacement.

Key Man cover thus covers the loss of a key player and keeps the Company on a financial even keel, so far as possible, if one of the key players dies or is long term disabled. It does not fund the purchase of the dead shareholder's shares, as the money is inside the Company, not in the hands of the surviving shareholder.

<u>Life Cover (Loan)</u>

One shareholder may have lent the Company a lot of money on loan account to provide capital for the Company's operations. It would be expected by the dead shareholder's executors that this loan should be re-paid immediately after his death. Not only will the Company have to replace possibly a key man, but also find the cash to re-pay the loan account immediately after the death. This may not apply here at present but may do so in the future.

This is likely to cripple the surviving shareholders who will need to replace that loan from their own resources. It is also possible that the dead shareholder has given a personal guarantee to the Bank to cover the Company's overdraft and this would be sought by the executors to be released, but would only be released on provision of other funds or security from the continuing shareholders, which they may not have.

One way to cover this is for the surviving shareholder to take out a life policy on the life of the lending shareholder with a substantial loan account to the Company, for the amount of the loan. The premiums would be paid from their own resources, there would be no tax relief and the policy proceeds would be tax free in their hands.

There should be a shareholders agreement and one of the clauses would be that the surviving shareholders would procure re-payments of any loan by the dead shareholders estate as soon after death as possible, and that this should be covered by life assurance.

If at the time of death, the loan is much lower than it was at the time the policy was taken out then, the surviving shareholder would have a bundle of tax-free cash, after lending money to the Company to enable it to repay the loan. If at the time of death, the loan is much higher than it was at the time the policy was taken out then, the surviving shareholders would then only have to find the extra difference.

Cross – Life Assurance

If one shareholder dies, the surviving shareholder will have to decide whether they want to have his widow/widower retaining a substantial stake in the business of whether to buy her out at market value.

The deceased shareholder will have probably preferred (and expected) to insure that his widow/widower would receive the value of the shares at his death. After all, what might happen if he is not a director with special voting rights, the continuing director could devalue the Company (a) by accidentally making un-commercial decisions or (b) by deliberately paying himself high perks and salary which would not otherwise be justified and thus reducing the value of the Widow's/widower's shares.

The survivor too will probably prefer to have the widow/widower bought out. Otherwise for every £1 of profit, a significant stake may have to go to her, even though not working in the business. And on the sale of the Company, the growth affected by the continuing shareholder/director, part of that growth would be kept by the widow.

So there should be an obligation in the shareholders agreement for the shareholders to take out life assurance on the lives of each other to cover anticipated share value to buy out the estate. It is not the current share value, but share value as it may be in a few years time.

If the estate, with the value of the shares is higher that the IHT nil rate band, the shares would have IHT Business Property Relief from IHT and this would reduce the IHT payable on the estate by a significant amount.

An option should be in place to be triggered after the death (if on death, Business Property Relief would be lost) exercise of the option by the surviving shareholders would be (say) within 4 months after the death, to buy the deceased shareholder's shares at full market value. The estate would have reduced IHT as there is no CGT payable on death, the widow would sell the shares at full market value and pay no CGT either.

The estate gets IHT relief, and CGT relief and cashes in the full value of the shares. The continuing shareholders get the widow "off their backs", fulfil any moral obligations and buy the shares at full market price, paying for them out of the life policy proceeds. They also obtain highest base acquisition cost to reduce CGT on an eventual sale of the shares by them, and everyone wins.

What if the continuing shareholders, even having received the life policy proceeds to cover the purchase, do not wish to purchase the dead shareholders shares? There must be no unconditional binding contract for sale, otherwise IHT Business Property Relief will be lost.

There will therefore be a second cross-option exercisable by the estate, exercised (if the executors wish) between 4.5 months after the death and (say) 6 months. There should be no common time window of exercise; otherwise the Revenue may claim that the cross-options exercisable in an identical period may have the effect of an unconditional binding contract for sale. Hence the two-week gap between the periods.

How is the cross- life insurance to be taken out? The continuing shareholders B/C can take out the policy on the life of A and receive the policy proceeds tax free, or A

can take out the policy himself, writing the proceeds in trust for B/C as beneficiaries. In either way, B/C receives the policy proceeds tax free in their hands.

If all the shareholders are of similar age and health, there is nothing much to choose between the two. But if A is (say) 50 and in poor health and B/C are in their 30's and in excellent health, and all want to have life insurance on the others lives, then B/C will pay a fortune to insure A's life, and A will pay only pennies to insure B/C's lives, because the risk of early death of B/C is that much lower.

In that case, A may be willing to take out a life policy in his own name, written in trust for B/C and pay the premiums himself, to ensure that his estate receives the full cash value of his shares as soon as possible after death, and certainly within 6 months or so.

If they all wanted to pay equal premiums, then the total could be divided by three. The Company could fund the payment and 1/3 of the total payment could be added to the directors/shareholders salaries, subject to PAYE and NIC. The premium payment would not be a Company expense in the profit and loss account.

The Company must not pay the premiums out of its own resources and claim tax relief on these payments, otherwise the Company is likely to be taxed on the policy proceeds when they fall in. Also, the value of the Company will be inflated at death if the policy proceeds fall into the Company, and the estate will still own the deceased shareholder's shares. The position sought to be solved, will just be made very much worse.

There is another possibility if the Company is not worth a great deal, the majority shareholder D is 55 and wanting to retire in 5 years or so, with a bright young man E working in the business who has not much in the way of personal funds. The more E does in developing the business and making money for the business, the more he will have to pay D, the outgoing shareholder, on D's retirement. This is hardly a great motivation for E. E could have added to his salary a sum equal to the CGT annual exempt amount (£7,900.00 for 2003-4) after deduction of PAYE and NIC. E could then purchase a tranche of shares each year at a price to let D sell a chunk of his shares to E over 5 years CGT free.

After 5 years E would be under obligation to purchase the value of D's shares at full market value. But it would only be on a much smaller percentage of Company shares than what it was when D was aged 55. It might be possible for the Company to purchase back D's shares, if the Company law and tax conditions were satisfied.

It would be possible for D to take payment by instalments, if E is buying personally. (Instalment payments on a purchase of own shares by the Company are very difficult). D would claim CGT retirement relief (hopefully no CGT at all) and be able to collect the instalments over the next few years, enabling him to be brought out in a tax advantageous way. There are available many permutations of the above, each to be tailored to individual circumstances.

Detailed advice should be sought in advance from the clients' and the Company's accountants and tax advisers, because the particular circumstances of each case are never identical, and tax law changes on a regular basis.