Alchemy
Advisory Services Ltd

KEY GUIDE

Business succession planning

When disaster strikes…

What happens to a business if its owner or co-owner dies or falls seriously ill? Much will depend on the type of business – sole trader, partnership or limited company – but unless there has been some advance planning, the chances are that there will be disruption, arguments and the strong possibility that all or part of the business will end up in the wrong hands.

So if you are a business owner, business succession planning and insurance is important. It is quite simply the process of planning for what you want to happen if you (or your co-owner, if you have one) were to die or fall seriously ill.

The legal position on the death of a business owner will depend on the type of business entity.

- **A sole trader business automatically comes to an end**. The business may still have a value – stock, buildings, or assets such as equipment and vehicles and goodwill – but the business itself will cease to exist legally.
- **A partnership may come to an end** if the partnership agreement does not set out that the business should continue.
- **A limited company continues** but the owner's shares will pass to their beneficiaries through their estate in line with their will or the intestacy rules if no will is in place.

Action point

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Sole trader

The issues

When a sole trader dies, their business dies with them, legally speaking. The business's assets will form part of the sole owner's estate and pass on to beneficiaries under the terms of their will. If the owner has not made a will, the intestacy rules apply; in effect, the state lays down who the estate should pass to.

If the estate is large enough and is not left to a spouse or civil partner, inheritance tax (IHT) can be payable on all assets above the nil rate band (£325,000 standard amount in 2017/18). The good news is that most trading businesses are not subject to IHT – if you are unsure about yours, you should certainly take advice.

Several issues can arise:

- Paying the IHT bill if the business does not qualify for the normal 100% tax relief.
- Passing on the business – perhaps to an employee or to a family member.
- Paying the liabilities that the business has incurred. These could include outstanding rent on premises, unpaid tax, an overdraft or business loan.

The solution

In each of these instances, the basic requirement is to create a capital sum, preferably outside the estate in order to minimise IHT.

This could be achieved with the help of a suitable life insurance policy. Generally, we recommend that sole traders in this position take out life insurance policies on their own lives and put the policy into a trust that will receive the proceeds on their death and pay them out to the beneficiary.

The exact solution depends on a number of factors, but here are a few examples:

Scenario	Action taken
James, who has no close family, wants to pass his engineering business to his production manager, Ken, when he dies. Ken would not be able to buy the business's assets on death, nor could he afford to pay the life insurance premiums.	Instead, James takes out a policy on his own life, in trust for Ken. On James' death, Ken has a lump sum to be able to buy the business assets and continue running the business, now under new ownership. Having this arrangement also gives Ken a strong incentive to remain with the business, and is valuable as a succession planning tool.
Melanie plans to leave her shop to her daughter Sam, but calculates that on her death, IHT of around £200,000 would be payable on the rest of her estate. She is concerned that Sam would have to sell or mortgage the shop in order to pay the IHT bill.	To counter her concerns about her daughter settling the IHT liability, Melanie takes out a life insurance policy on her own life and assigns it to Sam. Sam then pays the premiums and, on her mother's death, has a sum of money she can use to pay the IHT bill.
Peter has a sole trader business on which the overdraft increases to £50,000 at certain times of the year. He reckons that other liabilities at any time might amount to another £35,000. He thinks that the rest of his estate would be spoken for and he does not wish to leave his widow (who is his legatee) with liabilities and worries about paying these amounts to creditors.	In this case, Peter could take out a life policy on his life written in trust for his wife. This would provide her with funds in the event of his death which she could use to settle any potential liabilities.

Action point

You can create a capital sum with the help of a suitable life insurance policy.

Partnership

The issues

A partnership is a business owned by at least two people. Unless there is some specific provision in the partnership agreement (and very many partnerships have no formal agreement), a partnership ceases when a partner dies. When that happens, the deceased partner's estate becomes entitled to their share of the business.

This can mean a choice for the surviving partner or partners. They could:

- Pay the deceased partner's estate a sum of money they all agree to be the value of the deceased partner's share.

- Carry on in business together with the deceased partner's spouse or other beneficiary – even if the new partner has little to contribute to the success of the business.

For example, John and Jane are in partnership and Jane dies. Jane's sole beneficiary, her daughter Kylie, is keen for the business to continue, and so is John, who could not afford to buy out Kylie's interest anyway. Unfortunately, Kylie is unable to play any active part in the business and John resents having to split the partnership's income with a sleeping partner who contributes nothing other than capital to the business.

The solution

John and Jane could have done some succession planning along the following lines. Two main options are available to meet such needs, and are illustrated below. Other options are available, but they are generally not as attractive.

A double option agreement (also known as a cross option agreement)	Under this type of arrangement, the surviving partner has the option to buy the share in the business from the deceased partner's estate. In other words, they can make the estate sell the share in the business. The deceased partner's estate can also exercise an option to force the surviving partner to buy. There must be an agreed basis for valuing the business. Generally, the partners take out life policies on their own lives, which are written under a special business trust to benefit the other partner. So when Jane died, John would have been able to afford to buy out Jane's share from the proceeds of the policy on her life. Kylie would have money and John would have control of the business.
Automatic accrual	Under this type of arrangement, the surviving partner (or partners) inherits the business, but the family receives the proceeds of a life policy. On Jane's death, the business passes automatically on to John. No buyout is involved. Instead Kylie gets the proceeds from a life insurance policy Jane took out on her own life, written in trust for her beneficiaries.

Action point

Generally, the two most attractive options for succession planning are: either a double option agreement (also known as a cross option agreement) or automatic accrual

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

There may also be a need to insure the lives of all the partners to cover potential liabilities that might arise on their death – perhaps to pay off an overdraft or other creditors.

Limited company

The issues

Companies continue after a shareholder's death, but the basic succession issues are similar to those facing a partnership. The key is to make sure that the shares end up with the surviving shareholders and the deceased shareholder's family receives some money.

Generally, the deceased shareholder's beneficiaries will want financial compensation in return for their shares, assuming that they do not plan to continue in the business. There may also be the need to pay off creditors on an owner-director's death and this should be dealt with separately.

If we return to the earlier example of Jane and John and assume that rather than being in partnership they were actually co-owners of a limited company, we can see the same issues apply. John would probably still want to be able to run the business without having to worry about Kylie being involved and Kylie would want to be compensated for giving up the share of the business she inherited.

The solution

Action point

Take expert advice as soon as possible. Taking the opportunity to plan for the unexpected can help crystallise what you want to happen to your business after your death.

A double or cross option agreement is often used for company shareholder succession planning. If a shareholder dies, their beneficiaries can require the remaining shareholders to buy them out or the remaining shareholders can require the beneficiaries to sell their shares.

This means that John could insist that Kylie sells him the shares she inherited from Jane. It also means that Kylie could insist that John buys her shares. If neither of them exercises this option, however, the business continues to run with John and Kylie now being joint owners.

One advantage of double options is that they do not affect the entitlement to IHT business property relief. So the deceased person's shares in a trading business can usually pass down to the beneficiaries free of IHT – unlike most other assets.

To provide the funds, each shareholder takes out an own life policy written under a special business trust to benefit the other shareholders.

Serious illness

Of course, it is not just the death of a business owner that can stop a business. If a business owner suffers a critical illness such as a heart attack or cancer, it may not be possible to continue in the business either temporarily or permanently.

Let's consider a couple of examples:

- **Mel** is diagnosed with cancer and is unable to continue to work. His business partner, Chris, would like to carry on running the business and buy Mel out. Unfortunately, he cannot afford to do this and they end up with no choice but to dissolve the partnership and split the assets of the business. Mel gets less than he would have hoped for his share of what was previously very much a going concern and Chris is left having to start again in effect.

- **Anita** is the managing director of a small retail company that she owns jointly with her brother David and sister Jenny. Unfortunately, Anita suffers a heart attack and is strongly advised to take things a bit more easily from now on. She would like to step back from the business and ideally sell her shares to her siblings, but with no arrangements in place there is no mechanism for this to happen. More importantly, David and Jenny have no funds to afford to buy her shares.

Expert advice, taken before the event, could have helped in both of these cases. A suitable critical illness insurance policy is probably the best way to provide protection against the financial consequences of having a serious illness. These policies pay a cash lump sum on diagnosis of a specified critical illness or disability.

The policies are normally written in trust for the other business owners, along with an agreement between the business owners about the circumstances in which the share in the business should be transferred. In this case a 'single option' agreement would allow the sick person the option of selling their shares to the others (who would have to buy) but would not allow the others to 'force out' the sick person.

How can we help?

When we advise clients about business insurance and succession planning, we start by finding out the most important issues in each specific case. Once these have been identified and prioritised, we can then recommend a suitable way forward.

In doing so, we will advise on:

- The options available and their costs.
- Tax implications.
- Methods of valuing the business.

The death or critical illness of a business owner can lead to unexpected or undesirable consequences for those left behind. Taking the opportunity – well in advance of such an event happening – to plan for such a situation can help crystallise what you want to happen to your business after your death, and to identify how best to ensure that this will actually come about.

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