



Chartered Financial Planners



KEY GUIDE

# Business succession planning

# Introduction

## WHEN DISASTER STRIKES...

If you are a business owner, business succession planning and insurance is important. It is 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.

If this happens, family and business partners can be left in a complex situation. In some instances, the business ends up in the wrong hands, or in worst cases can fail. These issues apply to sole traders, partners and shareholders in limited companies, and all of this can be avoided with some sensible succession planning.

---

## Contents



### SOLE TRADERS

Your business is one of your assets and can die with you



### LIMITED COMPANIES

You need to plan for your shares to end up in the right hands



### PARTNERSHIPS

A specific partnership agreement can ensure your business continues to be viable



### SERIOUS ILLNESS

Critical illness can hit at any time and affect your business without sensible provision



# Planning for your business

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.

## IF YOU'RE A SOLE TRADER

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.

### The issues

If the owner has not made a will, the intestacy rules apply; in effect, the state decides who the estate should pass to. If there is a spouse but no children, the situation may be reasonably straightforward, with the spouse inheriting everything. However, where there is no spouse, or there are children involved, things can become considerably more complicated.

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 2018/19 and 2019/20), meaning that the government can become one of the largest beneficiaries of your estate. The good news is

that most trading businesses are not subject to IHT – if you are unsure about your status you should 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 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 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 intended beneficiaries at the right time. It is often said that the benefits of a trust lie in ensuring that the 'right money' ends up in the 'right hands' at the 'right time'.

### Planning point

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

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

Scenario	Action taken
<b>James</b> , 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.	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.
<b>Melanie</b> 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 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.
<b>Peter</b> 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 insurance 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.

## IF YOU'RE IN A PARTNERSHIP

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.

### The issues

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 husband/wife or other beneficiary – even if the new partner has little to contribute to the success of the business.

## EXAMPLE

### Legacy tensions from a partnership

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)

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**

The surviving 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.

The 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.

**IF YOU'RE IN A LIMITED COMPANY**

Companies continue after a shareholder's death, but the basic succession issues are similar to those facing a partnership.

The key is to ensure the shares end up with the surviving shareholders and the deceased shareholder's family receives some money.

**Planning point**

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

**The issues**

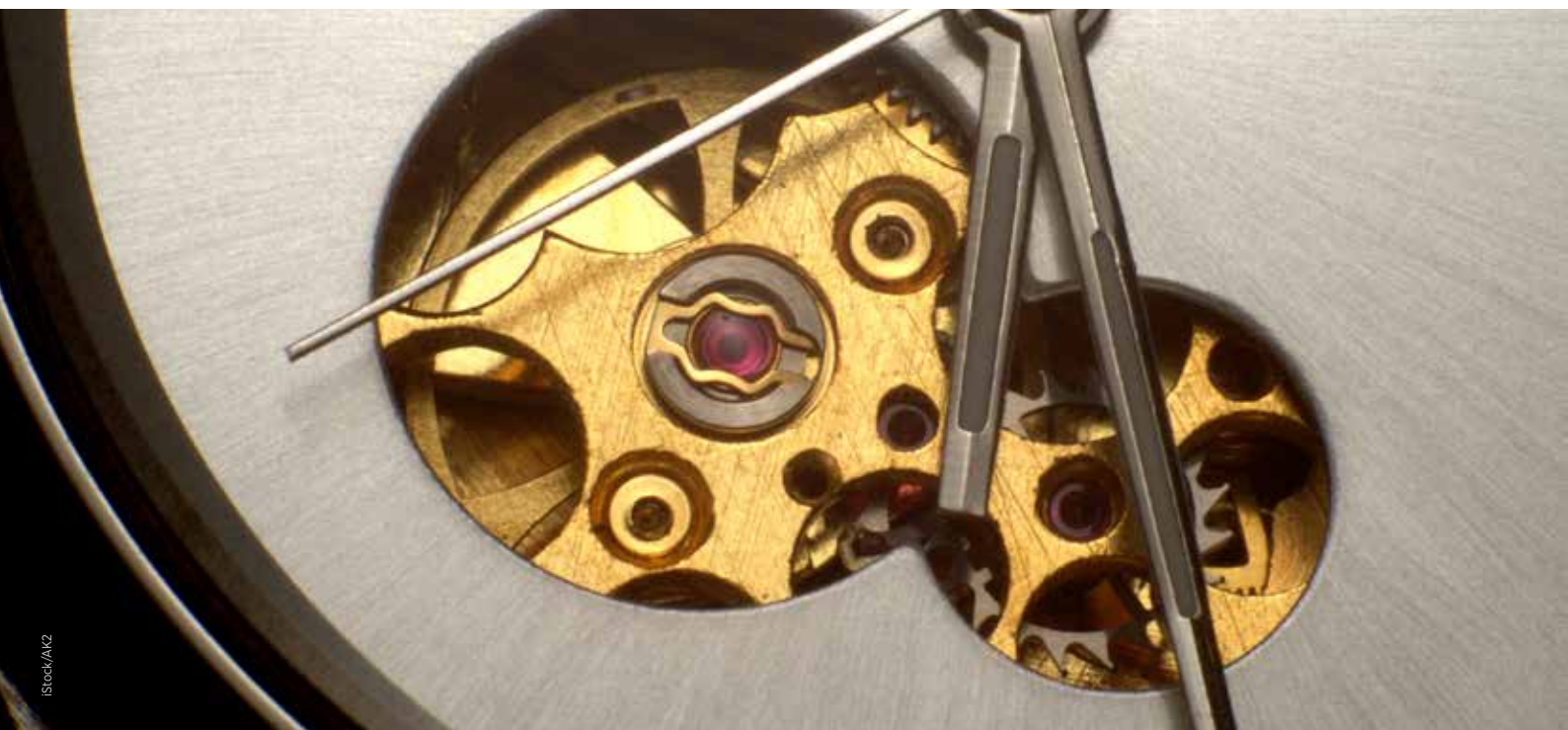
Generally, the deceased shareholder's beneficiaries will want financial compensation in return for their shares, assuming they do not plan to continue in the business. There may also be the need to pay off creditors on an owner-director's death and this should be dealt with separately.

If we return to the earlier example of Jane and John, and assume that rather than being in partnership they were 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**

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. Good planning can ensure that, should this disaster strike, the needs of the sick business owner, their family, business partners and co-shareholders can all be protected.

Let's consider a couple of examples:

Scenario one - Mel	Scenario two - Anita
<p>Mel is a partner in a small engineering firm. He is diagnosed with cancer and is unable to continue to work.</p> <p>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.</p> <p>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.</p>	<p>Anita is managing director of a small retail company. She jointly owns the business with her brother David and sister Jenny.</p> <p>Unfortunately, Anita suffers a heart attack and is strongly advised to work less 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.</p> <p>More importantly, David and Jenny have no funds to buy her shares.</p>

In both of these situations, disaster could have been avoided. Had they taken expert advice before the event, arrangements could have been made to ensure that both ended up with the outcome they desired.

A suitable critical illness insurance policy would have been the best way to provide protection against the financial consequences of having a serious illness in both cases. These policies pay a cash lump sum on diagnosis of a specified critical illness or disability.

### Scenario one - solution

Mel and Chris could each have had a critical illness policy in place. Depending on how this had been structured, it could either have allowed Chris to buy out Mel's share of the partnership, or simply provided Mel a lump sum of cash, with the business automatically passing to Chris.

In either case they would have achieved their desired objective.

### Scenario two - solution

Had Anita and her co-directors each had a critical illness policy in place, it would have been possible for Anita to step back from the business without financial disaster for her or her siblings.

The business would have ended up in the hands of David and Jenny, whilst Anita would have been left with a lump sum of money to provide for her needs.

When using critical illness insurance in these contexts, 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.

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 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.

The Financial Conduct Authority does not regulate advice on trusts or tax advice.



## 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. Just as we saw above, this means understanding both the structure of your business and your aspirations. Once these have been identified and prioritised, we can then recommend a suitable way forward.

In doing so, we can help you to understand:

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



Chartered Financial Planners



**Homecroft Wealth**

58 Station Road  
West Oxted  
Surrey RH8 9EU

tel: 01883 338 467  
fax: 01883 717 919  
email: [info@hcwealth.co.uk](mailto:info@hcwealth.co.uk)  
website: [www.homecroftwealth.co.uk](http://www.homecroftwealth.co.uk)

Homecroft Wealth is the trading name of Homecroft Financial Management Ltd which is authorised and regulated by the Financial Conduct Authority.

