Shareholder Protection & Partnership Protection

How to protect your business and your family.

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Small to medium enterprises face a variety of challenges today if they are to survive and thrive. If you are a typical business owner then you will want more than survival — you want to create an above average lifestyle and have financial independence and take control of your working and personal life. There is no better way of achieving this than by running a successful business.

Statistically, the odds are against you, as you probably already know. It is common knowledge that 80% of businesses fail within five years. When you consider all the effort, risk and passion that go into starting a business, this is both sad and avoidable.

So where do most business owners go wrong? There are two key reasons for business failure. Interestingly, they are not related to general economic circumstances, rather they are self-induced.

The two key reasons are:

1. Failure to take appropriate advice

2. Unwillingness to adapt to change

Running a business can be stressful as a great deal of time can be expended on dealing with day to day issues and crisis management. Of course, a business owners time would be better spent on essential planning for the business, including time spent on:-

Business plans

Financing

Cash-flow forecasts

Profit and loss statements

Credit control

Budgeting

Taxation

Maintaining staff

That is quite apart from all the other issues of running a business. So it is understandable that so many business owners find so little time to consider forward planning.

Time spent on forward planning is essential to ensure the success of the business. It is essential to include within the forward planning time to put in place properly constructed Partnership Agreements or Shareholders Agreements. These are the most important documents for any business owner. As they provide for certainty of control of the business and for business continuity.

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To understand why this is so, we must first review what these agreements do.

The agreements control the transfer of ownership in a business when certain events occur. Typically these events include the death of an owner and a sale and transfer of business from one owner to another, or to an outside party.

In addition the agreements should include the transfer of ownership to take effect upon an owner's permanent and total disability, termination of employment, retirement, bankruptcy, divorce. Or even a business dispute among the partners or owners.

For each of these events, the business agreements may require the business or the remaining owners to purchase the departing partner or owner's share; or it may give options to the other partners or owners to buy that partnership or ownership interest.

Advantages

- Ownership in the business can only be transferred in accordance with the agreement. This benefits both the owner wishing to transfer shares of the business and the other parties wishing to acquire part ownership. In the first instance, the agreement can assure a partner or owner wishing to sell, or his estate, of a purchaser for fair value and upon terms and conditions that are mutually acceptable. For the remaining partners or owner the agreement means that any transfers of ownership must be made, or at least offered, to them. This eliminates the threat that an outside party or a co-owner's spouse or children will become owners or partners of the business, thereby diminishing management, control and value.
- Valuation is set not only for purposes of a sale but also for inheritance tax purposes (if set up correctly). Privately owned businesses are notoriously difficult to value. Your idea of your business's value at your death may be much lower than the HMRC's.

Therefore the need for Shareholder/Partnership Agreements and associated planning, including provision for protection insurance is of great importance. Every partnership and every unquoted company should set time aside to put such agreements in place. This includes family firms where family succession is likely.

If they have existing arrangements, they should carry out a review of them. There is a need to ensure that business owners protect the investment they have made in their business in order to ensure the continuity of the business and to ensure their families obtain the equivalent benefit of value. The areas of concern can be summarised as follows:

The content of and values agreed in the following areas

1. Partnership/Shareholder Agreements
2. Proper 'Double Option Agreements'
3. Trusts for Life Policies
4. Inter-Vivos Discretionary Trusts
5. New Wills, LPAs etc.

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The reason that existing agreements should be reviewed is that many are defective, either in the manner established or by changed legislation. Not only are the agreements defective but the associated planning is often flawed.

In a large percentage of cases no planning has been done at all. However where planning has been undertaken it is almost always arranged incorrectly.

Typically it is found that a "business owner" has arranged for his or her share of the business to be acquired by the other "owners" in the event of his or her death; often with a life policy in trust and a "double option arrangement" i.e. a " put or call option" in place as well.

There are a number of flaws which are common and in the vast majority of the 'tens of thousands' of these arrangements in place very serious tax traps exist. These include, Capital Gains Tax, IHT, and POAT, It should be noted that not all of the adverse effects will occur, but as it is easy to avoid the possibility of them applying, why take risks?

If we examine in turn the various documents referred to in the earlier paragraphs, there is scope for a number of disadvantages to arise, unwittingly, when someone without considerable experience is involved in the planning.

For example when reviewing these important and essential agreements we often see, a precedent which says that in the event of the death of a "business owner" the other "owners" will buy his or her share, This a binding contract for sale and removes any "Business Property Relief', for IHT valuation from outset.

Of course if a spouse, with a domicile within the U.K. is willed the shares then receives the loss of this relief is not a problem. Such a loss however, prevents "proper"' planning for IHT and wastes a relief.

Similar provisions in a company's Articles and Memorandum referring to pre-emption rights can lead to some very unfortunate tax consequences. A case in point was examined in the case CIR v Johnson. This was a tax case where it was agreed between all of the parties that, but for a provision in the Articles and Memorandum stating that the shares had to be offered to the other shareholders for £1, that the shares were worth £6 each.

Because of this clause, however, the value for tax was £15 per share. This is because all of the rights of the share have to be valued, and although you might buy my shares for £1, I might be able to buy yours for £1 also. This of course would enhance their value to me.

In Double Option Agreements the problem, with these is that often, and nearly always, the price to be paid is quoted to be "the value of the business as valued by the firm's accountant" or some similar provision. This is a very unwise provision in our view.

Firstly it can create a conflict of interest for the accountant who is not usually an expert in such matters. Choosing between business owners who are likely to be able control whether or not his appointment is renewed giving him income for the next few

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years' and an executor who is not going to give him any more business. It is likely that any accountant will give the benefit of any doubt to the surviving business owners.

Another potential problem is the delay that ensues whilst the amount of value is being debated. The whole point of any agreement for the protection of business owners is that uncertainty and delay should be eliminated.

We would advocate the use of a professional valuation service which undertakes the valuation in proscribed form and in such a way that is acceptable to HMRC.

The family of the deceased business owner needs the money quickly and the remaining owners' need instant control of the business to keep it going.

In most cases valuing a company shareholding is more an art than science. A shareholding may very well be worthless if it is the key innovator who has died. Would want his family to receive nothing if on his death the company ceased to have marketability?

When attempting to arrive at a fair value for the business, so as to agree a value in advance and arrange a suitable level of life insurance. We would not advise that you accept a value set by the accountant for the business or the even by the business owner, as neither is unlikely to have any perception of true value of the business.

We would advocate obtaining both a professional valuation and an indicative value by generally asking the business owners "If I were to write a cheque today for your share of the business, how big would that cheque have to be?"

A reasonable value to agree upon will normally be somewhere in the middle of these two figures.

This value may not cover his past efforts and loss of future earnings and capital gains as a result of his death. The value should be realistic based upon the recent trading history of the business.

Once valuation is agreed, life insurance policies should be arranged for this amount and the amount of life insurance should equate to the valuation agreed. It is better practice to agree in advance the value of the business on the death of a business owner. The business owners could enter into an agreement that this should be the value of the term policies written in trust on their lives for the benefit of the survivors. This should be reviewed regularly and updated. The agreement should say so. This way everyone knows how much money a family is going to receive in the event of the death the business owners.

Another source of error in these arrangements is that often the term insurances are arranged incorrectly. They should be arranged to ensure that the money is available to the survivors quickly and passed onto the beneficiaries. If the life insurance policies are written correctly payments can be facilitated often within a matter of a few weeks of death.

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This gives the survivors "certainty" and will certainly make life much easier for the families of the deceased business owner. It will also allow the surviving owners to take control of the business with a minimum of disturbance, assuming the agreements allow for this.

Life Policy Trusts

In the vast majority of cases these are merely routine " trusts with discretion" otherwise known as a Power of Appointment Trust, provided by the Life Office who writes the Life Policy.

The rationale for using these trusts is that by making the first beneficiaries Partners or Shareholders in the business, with the power to substitute his family (often) including the partner himself gives 'flexibility'. It is claimed that when a new partner joins, or an existing partner on leaving the company, for whatever reason, wishes to retain the life cover a new policy does not have to be written.

This is, in my mind, a potential tax disaster waiting to happen. Life policies are not generally subject to Capital Gains Tax being protected by Section 210 TCGA 1992. However when these policies are written with a standard life office prepared "Interest in Possession Trust" with the power of appointment present, the Partners' in the business would be the original beneficiaries who hold "the Interest in Possession" i.e. they are the original beneficial owners.

There would also be a discretionary class, subject to a Deed of Appointment being entered into by the Trustees, which would allow the benefits to be passed subsequently, for instance on retirement, to the family of the business owner.

In this case when the deed of appointment is made the family have acquired their interest in the policy, in the view of the Revenue, for money or "moneys’ worth" as part of the financial arrangements for leaving the business.

A new owner who joined after the signing of the Double Option Arrangement would also similarly have his or her share of the policy taxed to Capital Gains Tax. The reason in both cases being that they were not 'the original beneficial owners' and they acquired their share in the policy for money or money's worth. These complications are often unseen or not considered.

Pre Owned Assets Tax

This will bring an annual charge to income tax where the policy owner has been left as a potential beneficiary under the trust. The charge is on 5% of the policy value. Thus for example a policy for £100,000 will bring a tax charge of £2,000 pa. (£l00,000 x 5% x 40%). I can see many tax penalties arising as advisers, generally, do not seem to have grasped the scale of the problem - leaving problems for PI insurers to hopefully resolve.

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The Wills

Wills should be written in such a way that all of the shares in a business should never be left to exempt beneficiaries e.g. Spouses. To do this is a complete waste of a relief. While it may be desirable for the surviving spouse, providing he or she has the ability to run the business, to have control, having the ownership is not necessary.

Control is the only imperative. There is absolutely no point in willing all of the shares to that spouse in the vast majority of cases.

Firstly, by passing them to someone other than the spouse, you dilute the spouse's shareholding which has, potentially, IHT and Capital Gains Tax benefits.

If it is desired that the spouse is to control or run the business, then he or she can do so as trustee of the discretionary trust set up to hold the business property and "Nil Rate Band" of assets. The spouse can access any funds she requires by a loan from the trust thus creating a further deductible debt in her estate.

The surviving spouse can control the business, but the value of the shares is not included in the estate. Currently people would argue that with 100% Business Property Relief this is of no great concern.

This is, currently, so but changing legislation particularly with regard to inheritance tax and possible removal of the l00% Business Property Relief from most companies and partnerships then it is indeed a potential problem.

Should this change occur, or CGT be in point, worthwhile and sensible tax planning in this current regime must be beneficial. Care should always be taken to ensure that in the wills the trustees of the discretionary trust have power to run the business. A point sadly often overlooked.

The stricture of never leaving business property to an exempt beneficiary is tempered with caution if the property is only given relief at 50% as valuation problems can accelerate a charge to IHT. These should be viewed as "prime objects" to consider for a "Deed of Family Arrangement", either by disclaimer or variation.

If an Inter-Vivos Trust is used as the recipient, as it should be, in the cases where the business or company does not consist solely of family, then it is the trustees of that trust that enter into double option arrangement.

In which case in the will there is no need to provide a "replacement" discretionary trust post mortem as you can always use the same trust to accept both the business property and the Nil Rate Band and use assets or a charge as appropriate to satisfy that legacy.

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Discretionary Trusts

These should be set up with an initial gift of say £100. This is a useful figure as it enables the trustees to invest in Premium Bonds and thus save themselves an administrative burden each year preparing tax returns because they have no taxable income. There is also of course always the chance that they may win a major prize.

Once set up, these trusts should be reported to the Revenue in the normal way using both the initial notification form 41 G(Trust), and then subsequently completing the IHT 100.

Trustees should then meet on a reasonably regular basis and really the only matter to decide at that meeting is whether to invest the £100 in objects other than Premium Bonds unless any other funds have accrued. Notes should be kept of these proceedings.

The trust is also, of course, a useful vehicle for making gifts to children. In practice loans are more beneficial and protective than outright gifts, and the trust makes an ideal conduit, depending on the amounts involved.

If more than the Nil Rate Band for IHT is given, then a secondary trust with an interest in possession would be used to avoid a chargeable lifetime transfer.

Life Policies

These policies should be written on the basis of a simple trust with named beneficiaries.

In Partnerships this prevents the problems inherent in the people who receive the benefit being neither the original beneficial owners nor who have acquired their interest for money or money's worth and thus becoming subject to CGT unwittingly. Every time a new Partner joins or is appointed then necessarily they must rearrange policies.

Good planning practice will take into account the need to secure the livelihoods and living standards of the people who have created the business. When directing the scope of the additional planning, particularly Inheritance Tax Planning it is easy, in the enthusiasm to mitigate the tax, to forget that the owners (particularly if they are gifting significant amounts of property) need to secure their future lifestyle.

In my view therefore one of the first things that must be present in all good inheritance tax planning is certainty of income for the future. This can often best be done by considering the provision of a pension or maximising the contributions into pensions.

If the business is the major asset of that person then it is normal and tax efficient for them to have a pension funded by the company.

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The aim of correct partnership or shareholder agreements and associated business owner protection is that for business owners there should be certainty of control of the business. For the families of the deceased business owner it is important to ensure that the right amount of money should be in the right hands at the right time.

Family companies

In the case of family companies, it is wise to include protection for the business and beneficiaries from failed marriages or other personal disasters.

In the ease where a younger member of the family has been given shares, or acquired them otherwise, then on that family member it is sensible, and necessary to enter into a double option arrangement and a life policy for an amount that would protect his or her spouse and children, but leave the business in family hands. It is usual for a son- in-law or daughter-in-law to be given money, not participation, in most cases. The only way usually this can be achieved is by properly set up arrangements as outlined.

Done in the above manner these arrangements are:

1. Easy to administer
2. Tax effective
3. Certain as to outcome.
4. With professional guidance, easy to set up and implement
5. Not easily open to legislative attack

Conclusion

For all business owners partnership agreements or shareholder agreements and the associated planning, including life insurance and wills, are (if ignored or established incorrectly) – potentially of high financial consequence, yet often the costs of making these arrangements are of low financial consequence.

The planning for these agreements links into other important planning for business owners. Even more important therefore, that this type of planning is implemented correctly.

If you have any queries regarding the content of this publication please contact my PA Carol, telephone 0845 241 0207 or email: info@paretolawrence.co.uk

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Ray Best the author of this report has been involved in the financial world for over 30 years. He specialises in increasing the wealth of business owners. In his spare time, Ray is a keen poker player.

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Financial Reality for Business Owners.

Think Outside the Cash Box
Inheritance Tax Planning – My Way.

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