

# Tips on small business protection

Outline

Many firms would not survive the loss of a key person, as often only material business assets are insured. Business protection insurance protects a company against the death or serious illness of a business owner, key person, or highly valued employee. Advance planning helps to ensure that

your business is in a financially secure position and avoids potential conflict where shares are transferred to beneficiaries. This factsheet highlights vital insurance solutions for key people and business owners.

Insurance needs

The success of businesses, and particularly smaller enterprises, can often depend on the contributions of key individuals. The death or illness of a key person with specialist knowledge can affect profits, business contacts and contracts, and the development of the company. Insurance cover can mitigate the financial damages associated with the loss of a key person and facilitate the

funding of a replacement, so that the business can survive such challenging times. Insurance policies can also guard against the death of a business owner by providing funds to the co-owners to purchase their stake. This ensures cash is available to the deceased's beneficiaries and that the business can continue without the involvement of the deceased's family.

Business protection solutions

In the below table we compare key features of three different insurance solutions. A solution typically involves a lump sum benefit, although with differences in purpose, recipient, cover options, and tax treatment. Key person insurance

could also be based on an income protection policy that pays out a regular taxable installment to a business if the key person is unable to work because of illness or injury.

|   | Key person protection  | Share and partnership protection   | Relevant life protection                                     |
|---|--|--|--|
| Policy purpose                          | Safeguard business against the financial effects of death and, optionally, critical illness (eg. cancer or heart attack) | Lump sum to purchase the business interest from a passing or critically ill director/partner | Individual death in service lump sum benefit for an employee |
| Who can be covered?                     | Any key member of staff  | Owners of the business   | Employees of a small business                                |
| Policy proceeds to go to                | The company  | Surviving shareholders or business partners  | Named beneficiaries (eg. family members)                     |
| Is critical illness inclusion possible? | Yes  | Yes  | No (requires a separate policy)                              |
| Corporation tax relief on premiums?     | For employees <sup>1</sup>   | Yes <sup>2</sup>   | Yes  |
| Tax treatment of lump sum payout        | Taxed as a trading receipt (ie. subject to corporation tax)  | Free of inheritance tax, depending on arrangements   | Benefits are paid free of income tax and inheritance tax     |
| Share protection agreement needed?      | No   | Yes  | No   |

1 Tax relief available for key person policies on employees, but not for shareholding directors/employees, partners/LLP members or sole traders  
 2 Premiums paid by the company are taxable on the life insured as a benefit in kind

## Key person protection

Key person protection is designed for companies, not individuals. The business owns a life insurance policy on the life of the key person. Critical illness cover can also be included. Critical illness cover can include a list of specified illnesses such as cancer, cardiac arrest, heart attack, stroke, Alzheimer's and Parkinson's disease. It can also cover specified serious injuries, which are usually permanent, such as loss of a limb. When taking out a key person protection policy the business pays the insurance premiums and any claim payouts are then made to the employer.

When identifying key people, it's important to take an individual's position within the business into account. Eg., are they an employee without shareholding, a significant controller/director, or a member of a limited liability partnership (LLP)?

The position affects:

- What cover can be taken out (for partnerships in particular).
- The tax treatment of policy premiums and policy benefits.

For a key person in a partnership, the policy may be written in trust for the benefit of the other partners. LLPs can take out cover on the life of the relevant members, with the policy proceeds being shared proportionately among the members (or their estate through their share of the LLP, namely the capital account).

For non-business owners, the level of cover is often based on a salary multiple or contributions to the firm's revenues/profits.

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## Share purchase protection

Share protection arrangements enable fellow shareholders/business partners to purchase the business interest from a deceased co-owner, whose beneficiaries then have a willing buyer based on fair valuation principles. Critical illness, if included, gives the owner the option to sell their business interests if diagnosed with one of the covered illnesses. A typical solution comprises the following:

- Up-to-date will/power of attorney provisions.
- Share transfer agreement: How and at what price.
- Insurance solution to provide the necessary funds to purchase the share.
- Ensuring that documentation allows surviving owners and dependants to receive proceeds free of tax.

The simplest will provision involves business owners leaving their business interests to the surviving spouse. Trust arrangements may be opportune if the beneficiaries are children and an inheritance tax (IHT)-free asset transfer is available thanks to business relief. A business lasting power of attorney (LPA) ensures that the company can be managed should the business owner become incapacitated.

The share purchase agreement in the event of death typically takes the form of a double option agreement (which is also known as a cross-option

agreement). It gives the surviving owners an option to buy, and the beneficiaries of the former co-owner an option to sell the share in the business. The options can typically be exercised within three or six months from death or policy payout. Such an agreement is not binding in the eyes of HMRC, so those assets are not subject to IHT thanks to business relief.

Life insurance can provide the required funds, so that the share purchase agreement can be executed as planned. In most cases, an own life policy written in trust is most advantageous. Only special business trusts should be used, with sufficient flexibility to allow for changing circumstances, such as a change in the business ownership.

An insurance policy placed in trust for the benefit of the other shareholder ensures that the proceeds of the policy will be paid out directly to the beneficiary. It is therefore available immediately to fund the purchase of the former business partner's stake, without waiting for probate.

Share purchase protection arrangements need to comply with the company's articles of association. For instance, the company's articles might include pre-emption rights that give co-shareholders the option to buy shares disposed by other shareholders. Special arrangements need to be considered for partnerships.

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## Share protection insurance options

The main policy types used for share purchase protection are term insurance, flexible whole-of-life, and critical illness cover. Critical illness cover can be an additional benefit with life policies, or cover can be taken out on a stand-alone basis. Increasing cover level is an important feature of

many policies, as it ensures that the level of cover maintains pace with rising share values, either through a fixed amount (eg. +8% per year), or based on general price level (inflation) indices. Medical underwriting – the evaluation of your medical history to assess any pre-existing medical

conditions – may be required for larger sums insured, particularly when it involves critical

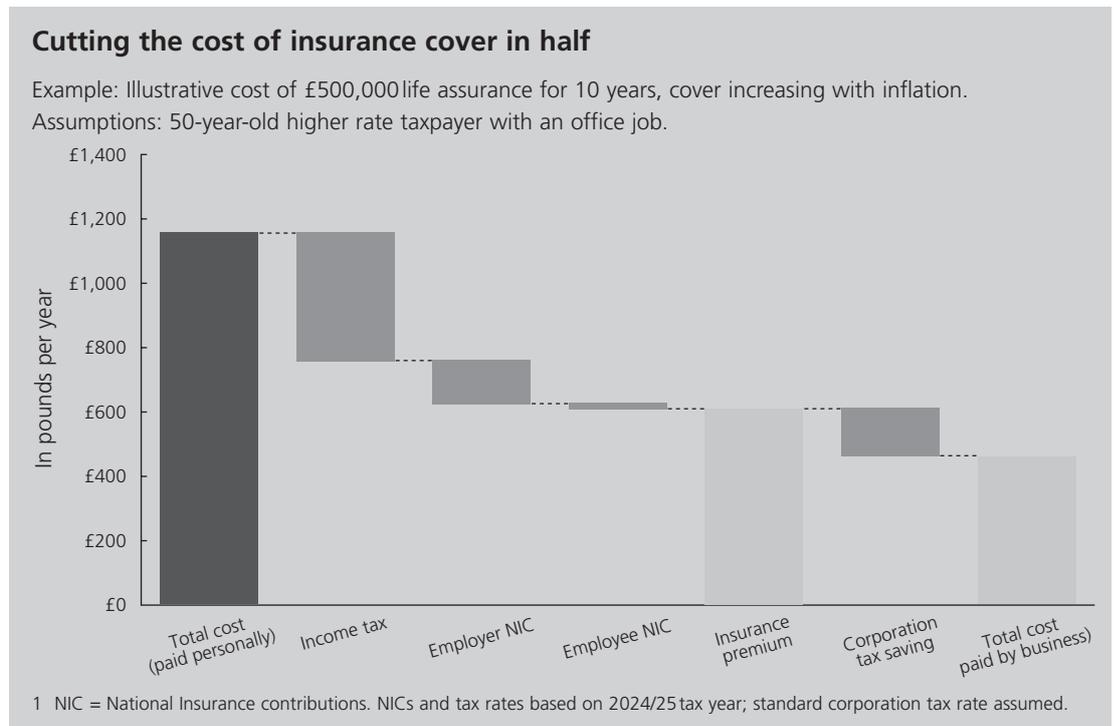
illness cover. Cover can be started straightaway while medical evidence is being processed.

| Policy types           | Feature   |
|------------------------|---|
| Term life insurance    | Lump sum cover and fixed premium for set period of time, typically five years. After that, the policy can be renewed (at higher premiums) or converted to a more permanent insurance contract without further medical checks  |
| Whole-of-life policy   | Lump sum cover throughout the life of the insured. Level of cover may be changed (subject to declaration of health processes). Premiums are regularly reviewed  |
| Critical illness cover | Lump sum cover on diagnosis of a specified illness and survival for a period of typically 14 or 28 days. Normally taken out in the same way as – or in combination with – life policies. If combined, the policy lapses after payout of the earlier of death, or diagnosis of a specified illness |

### Relevant life

A relevant life policy is taken out by a company on the life of directors or employees, but the benefits are payable to an individual (or charity). The lump sum cover cannot go beyond age 75 of the insured person. The insurance premiums are a tax-deductible expense for the business and are

also a non-taxable benefit for the employee. The double tax benefits of relevant life policies mean the insurance costs can be cut in half in contrast to paying individually (see illustration below). Note that relevant life policies cannot be used for shareholder protection.



### Case study

Director A and director B are equal shareholders and are thinking about what could happen if one of them died or became unable to work. None of their respective family members have the desire or skill required to be involved in the business.

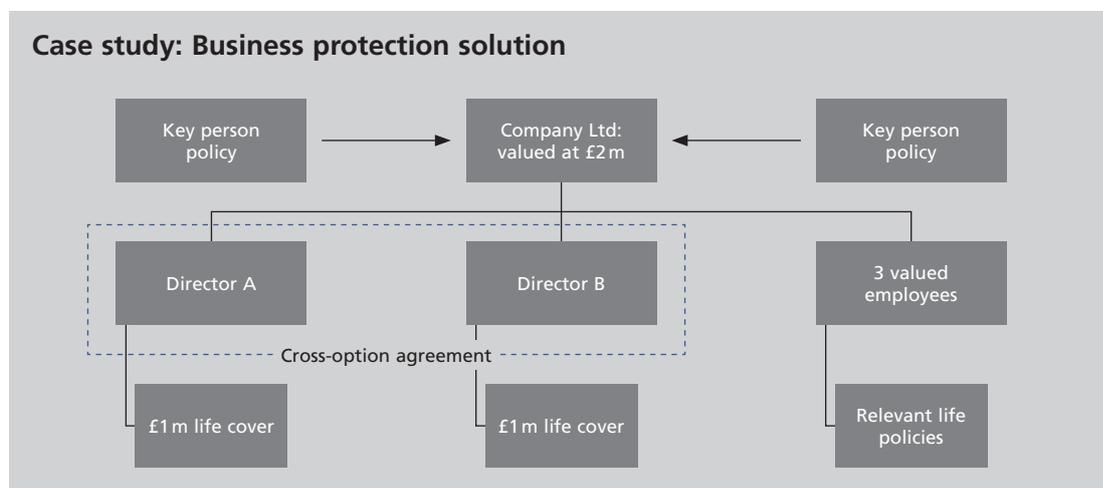
Both set up a will trust, so heir children can benefit from taking advantage of IHT Business Relief. No IHT is payable on qualifying assets, owned by a transferor for at least two years, into a discretionary trust. They each have a business LPA certified and registered with the Court of

Protection to ensure the business could carry on if one of them were to become incapacitated.

The business was recently valued at £2,000,000 by the company's accountant. Each director takes out a life policy in trust on their life for £1,000,000. The sum insured should reflect the value of the shares, but no more, and the combined insurance premiums are split equally to retain the commercial nature of the arrangement and avoid adverse IHT implications. The premiums are subject to income tax and National Insurance contributions.

A cross-option agreement ensures that if one of the directors were to die, the company can purchase the business interest from the passing director's estate, funded by the life insurance policy proceeds, which are available quickly and tax-free. The agreement states that the share purchase price will be based on the market value at the time through an assessment by an independent valuation expert.

There are three highly valued, non-shareholding employees and the company agrees to set up tax-efficient relevant life policies. The employees can name beneficiaries, such as spouses or children. There's no tax on the employee; the premiums are paid for by the company and are deductible business expenses, and therefore attract corporation tax relief.



Insurance solutions with Lumin

Speak to a Lumin business protection specialist to assess your specific needs and circumstances and match them with the right insurance solutions. This gives you the straightforward information you need to make informed decisions about protecting your business (and family). We recom-

mend a regular review of your insurance coverage. The review will check that the level of your existing cover matches your current needs, and that your insurance solutions are set up with the right features and in the most cost- and tax-efficient manner.

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