VitalityLife Business Protection

Case study – Ownership Protection Cover – GR Gardens Ltd

At VitalityLife, we recognise that Business Protection can seem complicated. This case study involves a set of circumstances that may be similar to many of your clients' and explains the choices to be made when placing their VitalityLife Business Protection Policy into trust. Also available on our website are completed Business Trust forms and option agreements using the facts of this case study as an example of how to fill in the Business Trust deeds and option agreements.

1. Background

Gary and Robbie, who are both married with young children, are the managing directors and shareholders of GR Gardens Ltd – a company that designs and manufactures novelty garden gnomes. Gary and Robbie each own 50% of the shares in the company. Business is booming and they are now developing the Norwegian gnome market. In fact, they recently received a £2 million offer for sale of the business which they declined.

2. Dealing with the financial needs

Gary and Robbie are well aware of the problems that can arise in respect of the ownership of the shares in the event of one of them dying or suffering a serious illness having recently witnessed the devastating financial repercussions arising from the unexpected death of a client who owned a market garden business.

Having discussed it, they want to ensure that should one of them die:

(a) The survivor will be able to retain complete control of the company; and

(b) The deceased's family will receive fair compensation in the form of a cash sum.

Should one suffer a serious illness, they would wish that person, based on the severity of that illness and their circumstances, to decide whether their shares should be sold to the other shareholder/director.

3. The planning solution

In order to ensure that, following the death of one of the shareholders (ie. Gary or Robbie), the company can remain under the same control, the shareholders establish an ownership protection arrangement.
This involves:

- Each shareholder executing a will that leaves the company shares to their spouse on the first death;
- Gary and Robbie each effecting a VitalityLife Business Protection Plan for a sum assured payable on serious illness or death equal to the value of that shareholder's share – £1 million in this case;
- Each Plan being effected subject to a Business Trust for the immediate benefit of the other shareholder; and
- Both Gary and Robbie entering a cross option and single option agreement so that:
  - In the event of one dying, the survivor would have the option to buy the deceased's shares from his estate and the deceased's legal personal representatives would have the option to sell the deceased's shares to the surviving shareholder; or
  - In the event of one suffering a serious illness, the seriously ill shareholder would have the option of selling his shares to the other shareholder. (In this respect, they have decided that they prefer the seriously ill shareholder to be the decision maker rather than the other shareholder).

There are some important points to bear in mind as follows:

- The arrangement must be commercial to avoid the inheritance tax gift with reservation provisions. As there are only two shareholders in this scenario, each should pay the premium on the other's policy. If there were more parties involved, then each shareholder should pay a proportion of the total premiums equal to the overall benefit that they were receiving under the arrangement through premium equalisation.
- A cross option agreement is used (as opposed to a binding contract of sale) as it maintains business property relief on a shareholder's death (which would be the case if a binding contract for sale was used).
- The sum assured under each shareholder's policy is £1 million – equivalent to what they regard as the current value of their interest.

This means that in the event of Gary's death, Robbie would receive £1 million in cash. If Robbie was to exercise his part of the cross option agreement, he could buy Gary's shares from his estate and end up with 100% of the company. Similarly, Gary's estate would receive £1 million for the sale of his shares. There would be no capital gains tax or inheritance tax on this.

All of these requirements can be achieved by using a VitalityLife Business Protection arrangement in conjunction with a cross/single option agreement.

4. The Plan in action

- Having taken financial advice, both shareholding directors set up a VitalityLife Business Protection Plan with a benefit of £1 million payable on death or serious illness.
- The Plans are written under Business Trusts for the immediate benefit of the other Director. Both Directors are trustees and they appoint their legal adviser, Gordon as an additional trustee.
- Each enters a cross option agreement to deal with the sale/purchase of their interest on death and a single option agreement to deal with the position should one of them suffer a serious illness.
- Let's assume Robbie has a nasty accident when operating some machinery at work.

  He never recovers from his serious injuries and dies. The planning could then have worked as follows:

  - Gary and Gordon make an absolute appointment of benefits in favour of Gary and pay £1 million to Gary.
  - Gary exercises his option to buy Robbie's shares.
  - Because Robbie has left all of his estate to his wife Jane, she receives £1 million and Gary ends up with 100% of the shares in the company.

It should be noted that should a claim arise because of a serious illness, the policy proceeds should not be appointed to the other shareholder until it is known that a sale will occur (ie. because the seriously ill shareholder has exercised his option to sell).

5. Completing the trust and option forms

(a) Trust forms

In order to establish each Business Protection Plan subject to VitalityLife's Business Trust, Gary and Robbie would each need to complete a trust form. The following looks at the action that would need to be taken in the context of Robbie (but Gary would need to do likewise):

- In Part A of the Trust, Robbie inserts his full name and address as Settlor (ie. applicant for the Plan and creator of the Trust).
- As each Settlor is the only life assured under the Plan, Robbie should insert his name in Part B as well as the date of his application.
- Robbie should insert the name of the company in Part C(i).
- Under the terms of the Trust, the death benefits (or benefits paid on serious illness) are held for the benefit of the beneficiaries. The initial named beneficiary ("the Default Beneficiary") is the other working director/shareholder, Gary, in the case of Robbie's policy. No insertion of names is necessary if the intention is that the surviving shareholders, ie. Gary will benefit in the share(s) in which they are then entitled to the business (ignoring the life assured). Gary will therefore be entitled to 100% of the death benefits under Robbie's policy.

- However, for the benefits to be paid to a Default Beneficiary, the trustees would first need to make an absolute irrevocable appointment in his favour.

It should be noted that the decision as to which beneficiary actually receives any benefit will be made by the trustees. Robbie should complete a letter of wishes to set out any guidance for his trustees to consider. At the present time, the only possible beneficiary under Robbie's trust would be Gary but over time this could change, say if the shareholders in the company change.

- Robbie would sign the Trust Deed in Part I and have his signature witnessed by an independent witness eg. his financial adviser.
- Robbie, as initial trustee, would then complete a Deed of Appointment of Additional Trustee(s). This is important because he is the only trustee and if he dies there will be no trustees left to administer the Trust and a further delay will arise. By appointing an additional trustee these people can act should the Settlor die. In the context of an ownership protection arrangement, it would be usual to appoint the other shareholders (subject to there not being more than three) and an independent professional adviser to the business – say the accountant or solicitor – as additional trustees. In Robbie's case he appoints Gary, and Gordon (the lawyer).
- In order for the arrangement to be commercial it is only possible for the other shareholders to be included as potential beneficiaries. This means that if there is a change in the ownership of the company shares, the trustees can make an appropriate appointment.
- If the Business Protection Plan includes Disability Cover for Business then provided both this and any Life Cover was held for the benefit of the beneficiaries under the Trust, the life policy gift with reservation rules in paragraph 7 Schedule 20 Finance Act 1986 would not be relevant.

(b) Option agreements

- There are two option agreements – one dealing with the position on death and one dealing with the position on serious illness under the Disability Cover for Business. As stated in 3 above, with the option agreement on serious illness, the parties need to decide whether to opt for an agreement on the basis of a single option (party who has illness decides whether to sell) or a double option (both parties have option to buy/sell). In this scenario, they have chosen the single option agreement.
- The option agreement forms are only drafts and need to be completed by Gary and Robbie after receiving advice from their legal advisers.
- Subject to that advice, Gary and Robbie should insert the date and their full names and addresses at the beginning of the agreement.
- The name of the "business" needs to be inserted in the definitions section – clause 1.
- In clause 7(i) they would need to decide how to deal with a situation where there was insufficient cash to buy the shares at the agreed price. Where there is insufficient cash, it would be normal for the shortfall to be paid in equal instalments. The number and frequency of such instalments needs to be inserted as does the amount of any interest payable.
- In the Schedule, each party should complete the "Specified Value" (ie the purchase price of the shares) if they want a fixed price. If no price is inserted the purchase price will be the market value of the shares at the appropriate time. The parties should sign as appropriate.