

# HM

Hall Morrice  
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KEY GUIDE

# Business succession planning



## Introduction

Owning a business can be a very rewarding experience. But what happens if a business 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 what remains may end up in the wrong hands.

So if you are a business owner, business 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) die or fall seriously ill.

What happens when a business owner dies depends on the type of business.

- **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 legally cease to exist.
- **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 shares held by the business owner will pass on to beneficiaries through the estate.



### Focus point

*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 laws of intestacy apply – in effect, the state lays down who the estate should pass to.*

## Sole trader

### The issues

When a sole trader dies, the business dies with them. 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 laws of intestacy apply – in effect, the state lays down who the estate should pass to.

If the estate is large enough (over £325,000 in 2013/14, including the value of any homes, business and other assets) and is not left to a spouse or civil partner, inheritance tax (IHT) is payable on all assets above £325,000. The good news is that most trading businesses are not subject to IHT.

Two issues can arise:

- Paying the IHT bill.
- Passing on the business – perhaps to an employee or to a family member.

### The solution

In both of these instances, the basic requirement is for a lump sum of money to be created, preferably outside the estate (to minimise IHT).

This can be achieved through a suitable life insurance policy. Generally, we recommend that the sole trader takes out a life insurance policy on their own life and either assigns it to the beneficiary or sets up a trust to pay the beneficiary on their death.

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

- James, who has no close family, wants to leave his engineering business to his production manager, Ken. 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's 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, so she 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.

## Partnership

### The issues

A partnership is a business owned by two or more people. Unless specific provision is made in the partnership agreement (and very many partnerships have no formal agreement), the partnership will cease on the death of a partner. When that happens, the deceased partner's estate becomes entitled to their share of the business.



#### Focus point

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This can mean a choice:

- The remaining partner or partners pay the deceased partner's estate a sum of money agreed to be the value of the deceased partner's share.
- The surviving partner or partners and the deceased partner's beneficiary carry on in business together – perhaps with the new partner having little interest or skills in 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

Two main options are available to meet such needs, and are illustrated below using the example of a simple two-partner business owned by Alan and Ben. Other options are available, but are generally not as attractive.

- **A double option agreement** (also known as a **cross option agreement**). Under this 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. 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, each partner takes out a life insurance policy on their own life, written under a special business trust to benefit the other partner. So if Alan dies, Ben can decide to buy out Alan's share from the proceeds of the policy on Alan's life.
- **Automatic accrual**. On Alan's death, the business passes automatically to Ben. No buyout is involved. Instead Ben's beneficiaries get the proceeds from a life insurance policy Ben took out on his own life, written in trust for Ben's beneficiaries.

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.

## 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 receive 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.



### Focus point

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### The solution

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

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

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.

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, and there needs to be an agreement between the business owners about the circumstances in which the share in the business should be transferred. This is one of those situations in which an experienced and expert adviser can be very valuable.

## What else do I need to know?

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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