# Business Protection

## Guide To Covering Business Liabilities

For intermediary use only – not for use with your clients

This technical guide details the need for protecting business liabilities, suitable solutions, and the impact and tax treatment of applying them.

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# 1 What are business liabilities?

| Liability | Description |
|---|---|
| Business loans | Usually fixed term loans, are granted on a repayment (capital & interest) basis. They are usually medium to longer-term loans.<br>The lender may require a charge over specific assets or a 'floating' charge over all the business assets. Personal guarantees from the owners are often required. This is especially so where a loan is made to a company, personal guarantees would then be typically required from the director.<br>The borrower may have already put life assurance and critical illness cover in place. Cover would normally be on the lives of the business owners. |
| Amounts owed by the business to the business owner | Business owners lend money to their business either by lending new funds or by leaving profits un-drawn (partners) or by not taking any declared salary or dividends (directors). These loans are usually repayable on demand. |
| Overdraft | Usually a line of credit, drawn down when needed, and used for working capital in the business, aiding the business's cash flow during accounting periods. |
| Redundancy costs | Sometimes businesses need to make employees redundant. Depending on the agreement with employees, a redundancy payment will be made which can range from statutory redundancy pay to a more generous payment offered by the employer either discretionary or incorporated into the contract of employment. |

# 2 The Need

If a business owner dies, suffers a critical illness or is away from work for an extended period due to accident or illness, any or all of the following may happen:

- The lender, fearful that the business is in decline or at risk, may (subject to the terms of the loan) demand an immediate reduction or repayment of the loan. Other creditors' attitudes towards the business and the monies they are owed may change.
- The lender may wish to reduce, or stop altogether, the current overdraft arrangements, demanding immediate repayment of the outstanding amount.
- The business owner on suffering a critical illness, or the personal representatives of a deceased business owner on death, may want amounts owed by the business to be repaid immediately. Cash may be needed for care costs, or to cover a short-term need for cash.
- Sometimes employees are made redundant due to the loss of profits arising after the death or illness of a business owner/key person. In this case, the business must fund the redundancy payments.

The impact on the business of the loss, whether permanent or temporary, of a business owner could be an immediate need for cash. Failure to find that cash may result in the business ceasing to trade.

# 3 The Solution

Life assurance cover (and/or critical illness cover) is an effective way of providing the cash needed in the event of a business owner or key employee dying or being diagnosed with a critical illness.

## Who needs to be protected?

The life or lives assured are those whose death (or illness) will cause business liabilities to be called for repayment. This is most likely some, or all, of the business owners themselves. It can also be a key person who is not an owner, i.e. an employee.

## How much cover is required?

Life companies look closely at insurable interest, so the cover on each life needs to reflect the expected amount of the financial loss arising on their death or critical illness.

| Liability | Description |
|---|---|
| Business loans | The amount outstanding on the loan or such a proportion as is appropriate for each key person/owner. |
| Amounts owed by the business to the business owner | The amount required to pay off at it's highest anticipated point (taking into account past experience and likely future levels). |
| Overdraft | The amount required to pay off at it's highest anticipated point (taking into account past experience and likely future levels) – or a proportion as is appropriate for each key person/owner. |
| Redundancy costs | The business could calculate the liability for each employee individually assuming they are made redundant today. Employees come and go, and redundancy payments increase with length of service, so it's not an exact science, but it should be possible to arrive at a figure with the business owner(s). |

It is important to take account of any existing cover (and whether critical illness cover exists) so that the owners are not over-insured. It is also important that they are aware when any existing cover is set to expire.

## Which type of protection policy should be used?

As the business loan will typically be on a capital & interest basis, decreasing term assurance is generally most appropriate, though level term assurance can also be considered for added flexibility (and at extra cost). The cover should be in force for the full unexpired term of the loan.

For overdrafts, amounts owed to the business and redundancy cover, level term cover is generally most appropriate, though whole of life cover could also be considered (and both could include critical illness cover). The term of the insurance might be to the business owners' expected retirement date, but it could be to any other date, e.g. perhaps a date when it is anticipated that the overdraft may no longer be needed. Where the amounts tend to fluctuate, the amount of cover should be reviewed frequently.

## How is the policy set up?

- For companies, the company would normally effect the policy on the life of each key person/business owner. Alternatively (in the case of business owners), each business owner could take out a policy on their own life, but subject to a business trust for the benefit of the co-business owners.
- For partnerships, the partners can take out a plan on their own life (or the life of an employee, as appropriate) subject to a Partnership Key Person trust for the benefits of the partners for the time being. Alternatively, if the partners are taking out cover for share purchase subject to business trusts, they can increase the cover under these plans. Limited Liability Partnerships, and partnerships in Scotland, can take out a plan in their own name on the life of each member/partner.
- Sole traders would take out a policy on their own life, and should consider whether the policy should be subject to a trust.

# 4 Tax position

<table>
<tr><th></th><th>Limited Company</th><th>Partnership/Sole Trader</th></tr>
<tr><td>Policies held by individuals</td><td>It is not possible for the cover to be written in this way.</td><td>For partners and sole traders, who are making the payments in a personal capacity, no tax relief would be available on the payments although the benefits would not suffer tax when paid into a trust.</td></tr>
<tr><td>Policies held by company</td><td colspan="2">Payments under a life assurance or critical illness policy would only be deductible (and the sum assured assessable) if:<br>(i) the sole relationship between the insured and the life assured is employer/employee<br>(ii) the policy is a term assurance<br>(iii) the purpose is to replace profit/reserve and not capital.<br>This means that payments paid under:<br>– a non-term assurance (whoever is the life assured) or,<br>– a policy (of what ever type) on the life of a partner or shareholder (more than 5% of the voting shares) or,<br>– a loan protection policy whoever is the life assured and whatever the policy type<br>can't qualify for tax deductibility. However, the sum assured should not normally be taxable.</td></tr>
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