Newsletter

BURGES SALMON

Family Business

June 2014

Welcome

Welcome to the latest edition of Family Business. This edition looks at preserving assets in the event of the death or divorce of a shareholder in the family business. There are also two important legal updates that you should be aware of if your company is either starting to implement auto enrolment (as almost all companies will be required to do) or if any employees hold shares or options in the company.

Contents

Don't lose your pensions tax protection!

Individuals who currently benefit from tax protection for their pensions savings are at risk of inadvertently losing that protection, as a result of the requirement on employers automatically to enrol employees in a workplace pension scheme.

Over the past few years, the government has reduced the ceiling on tax-efficient pensions savings that an individual can make (from £1.8 million to £1.25 million), as well as the annual amount that can be saved tax-efficiently. Individuals can take steps to protect their existing limits (so that these are not eroded), but it is vital to realise that such protection can be lost in certain circumstances.

The likelihood of the protections being lost is significantly increased by the requirement for employers automatically to enrol most employees into a pension scheme. The requirements for auto enrolment are being introduced in stages depending on payroll size but are applying to more and more employers. The risk is that if an individual with protected pension limits is inadvertently enrolled into a workplace scheme (or is even, in some cases, provided with death in service cover) they could lose their individual protection. It is important to be aware of this risk and identify any individuals who might be affected before auto enrolment takes place. Given the level of lifetime pensions savings involved, these individuals are likely to be at director level, including, possibly, non executive directors.

> *... if an individual with protected pension limits is inadvertently enrolled into a workplace scheme (or is even, in some cases, provided with death in service cover) they could lose their individual protection.*

Visit our website at www.burges-salmon.com

Divorce

Relationship breakdown is an all too common feature of modern society and the legal and financial issues which arise are often complex, particularly where a family business is involved. Until recently, divorce was rarely contemplated until it happened. However, we are increasingly seeing family business owners seeking ways to minimise the damaging effects of a divorce within the family, much in the same way that they plan for other possible eventualities such as illness or death. Similar principles also apply to the breakdown of civil partnerships.

What happens to an interest in a family business on divorce?

All of a couple's interests will be taken into account in determining a financial settlement on divorce including any interest in a family business, along with the other assets such as houses, pensions or investments.

The first task is to establish the value of those interests. Where there is co-ownership of a business, particularly with other family members, this is often a difficult and expensive issue to resolve and discounts for minority interests and liquidity frequently become the key issues. Even experts brought in to assist will often disagree. If an agreement cannot be reached ultimately a court may have to impose an arbitrary decision.

After considering value, the next stage is to decide what happens to the assets, including any business interests. In the absence of agreement, a court would divide them to achieve what it regarded as a fair settlement. This is done by applying a series of discretionary principles rather than fixed percentages or rules and inevitably the outcome is difficult to predict.

The court has wide ranging powers to redistribute assets as it sees fit and the starting point is usually to achieve equality. Although a court will often look to protect a business, they can transfer a spouse's interest in it or make orders that require a spouse to obtain a distribution of funds from it, or require the interest to be sold. The impact on the business can therefore be very significant.

What can be done to protect the family business?

Various steps can be taken to limit a family business' exposure to a divorce. The specific circumstances will determine which are appropriate and in our experience any advice taken should be across the board, combining asset protection with financial and taxation advice to ensure that the steps being taken meet the family's objectives.

Options include:

- **Pre or post nuptial agreements:** It is possible for a couple to enter into an agreement either before or after they marry with the aim of protecting the family business, often by ring-fencing any interest in the business from a financial settlement. Although these agreements are not currently absolutely binding, they are presumed to apply, provided they are done properly. The Law Commission has this year published a report with draft legislation to elevate their status and if the changes are accepted, it would mean that such agreements could be contractually enforceable, provided that the couple's needs have already been met. Even if the changes are not accepted these proposals are likely to be influential. Case law already shows the significant influence these agreements have on divorce settlements. We are preparing more and more of these agreements in conjunction with the passing on of shares or business assets to the next generation.
- **Controlling the ownership of shares:** Family shareholders of a company can establish a policy that shares in the family business can only be held by members of the original family, not their spouses, and that if such shares are required to be sold they must be offered to original family members only. The company's articles of association could also provide that shares transferred to a spouse should be bought back by the business in the event of a divorce. The court will always retain a discretion to make orders over any shareholding owned by either of the divorcing couple but at the very least such provisions may be influential.
- **Involving Trustees:** Instead of transferring shares outright to spouses or family members, consider transferring them to trustees to hold for their benefit. This cannot be guaranteed to take them out of account on divorce, but adds a further layer between the interest in the family business and the divorcing spouse and will make a claim by them that much harder.
- **Not getting married or not entering into a Civil Partnership:** This is the greatest available protection, provided the spouse or partner has no interest in the business themselves, as cohabitants do not have the same rights as spouses.

It is often possible to combine different steps to achieve greater protection, but early advice is recommended in every case as the options are reduced once a divorce is underway or imminent.

Transferring ownership

Research published last year by a major UK insurer suggested that businesses are massively underinsured against a number of risks. While it is tempting to think “they would say that wouldn’t they?” some of the statistics highlighted by the research are interesting. For example, the research found that although nearly half of business owners thought that if they died their shares would be acquired by the other shareholders, most of the companies surveyed had no insurance to meet the cost of doing that and one third of the respondents had not reviewed their articles of association since incorporation to check whether the transfer process would work in the way in which they intended.

The important point which this raises is that business owners should not only think about what they want to happen to the shares of a shareholder who dies but also about whether the necessary steps have been taken to ensure that this can happen. If there is conflict between the rights set out in a shareholders agreement, articles of association or a shareholder’s will, this may mean that the transfers cannot take place as planned. This can cause delay and cost and, in the worst case mean that the shares cannot be transferred as intended. This is particularly the case where a shareholder dies intestate and the articles and shareholders agreement are silent on the subject.

Each business and family will have its own unique circumstances, but a few general points to consider are as follows.

- **Protection of family ownership:** It is common for articles of association of a family business to contain a restriction on the transfer of shares to non-family members. The exact way in which this works will vary and needs to be tied in with provisions in other documents (such as the individual’s wills).

- **Cross options:** the transfer of shares can be managed by including “cross options” in the company’s articles which provide that if a shareholder dies his shares are automatically offered to one or more of the other shareholders, who have a first right to buy them. In this way, the ownership of all of the shares is kept within the existing circle of owners and the deceased shareholders’ beneficiaries receive value for their shares. Where cross options are used;

  - care needs to be taken to ensure that the transfer procedure is genuinely an option to acquire the shares (rather than a contractual obligation to acquire the shares) as a binding contract could jeopardise business property relief on the shares and trigger a significant charge to inheritance tax.

  - it is important to consider how a purchase by the remaining shareholders would be funded, because the arrangement may not be implemented if none of them can afford to buy the shares. A common approach is for the other shareholders to take out insurance to meet this cost. If insurance is used it needs to be reviewed periodically to ensure that the amount insured reflects the current value of the shares, and that the beneficiaries of policy are the right people. It may also be important to consider, from an accounting and tax perspective who pays the premium (the company or the shareholders) any consequences of this.

The important point which this raises is that business owners should not only think about what they want to happen to the shares of a shareholder who dies but also about whether the necessary steps have been taken to ensure that this can happen.

- **Consistency:** whether or not there are cross option arrangements in the articles, it is important to check that the provisions of the articles of association are consistent with other documents, so that for example, shares are not left to someone in a will only to find that the transfer is prohibited by the terms of the articles.

- **Other events:** shareholders may also want to think about arrangements in the event of a shareholder being critically ill or becoming bankrupt and forfeiting his shares as part of bankruptcy proceedings. In the case of illness it may not be appropriate for the shareholder to be required to sell their shares but there may need to be practical arrangements to ensure that the control of the business can be maintained effectively (for example it may be helpful to have powers of attorney in the event that a shareholder is unable to act for a period of time).

- **Continuity:** owners need to think about business continuity generally. The 2013 research found that nearly half of business owners thought that their business would be unable to survive the death or critical illness of a key individual. Even if there is insurance to allow the other shareholders to acquire the shares, it is important to consider whether the business is adequately prepared to survive the upheaval that would follow an unexpected death or illness. One answer may be using key person insurance to help the company financially over any transitional period but there are practical steps which can be taken too. For example, ensuring that the company has a properly developed board which can share responsibility, ensuring business contacts are shared and that there is a plan to deal with business interruption.

- **Providing liquidity:** one way to avoid tensions which can de-rail a family business is to ensure that family shareholders who want to realise the value of some or all of their shares have a way to do so. This can be achieved in different ways

continued overleaf

Transferring ownership *continued from page 3*

(either with the company buying the shares or other shareholders acquiring them) but it is important to have a mechanism which is fair and transparent and (as before) to ensure this fits in with other share transfer provisions. It is far easier to agree such a mechanism (including particularly the approach to valuation) in advance than to try to do so when relationships are more fraught.

It's not a pleasant subject to think about, but advance planning of this sort can ensure the survival of the business and that beneficiaries receive the value which they deserve. It can also mean that current shareholders can sleep more easily at night.

New rules regarding options and employee shares

If you have an employee share or option plan, or otherwise make shares or other securities available to people working in your business (including family members who acquired their shares by reason of employment rather than purely the family relationship), important changes have recently been introduced to the way you must report to HM Revenue & Customs. Failure to comply with the two new requirements could prove costly both financially for the company, and in lost employee goodwill if participants in previously "approved" approved plans lose their tax breaks.

The changes are as follows:

- All employee share plans (new or existing and whether HMRC approved or not), must be registered with HMRC by 6 July 2015. This is a mandatory requirement and must be done using the Employment Related Securities section of the PAYE online facility. The process can be started now and it is worth doing this as soon as possible.
- Annual returns to HMRC in relation to share plans must, from the 2014/15 tax year, be made online. While HMRC were previously somewhat benign in their approach to late filings, in future, failure will result in an automatic penalty and, significantly, previously tax-advantaged plans will lose their approved status.

If any of the information above is of interest please contact Doug Streatfeild-James or Jim Aveline.

Doug Streatfeild-James
Business structuring and governance
+44 (0) 117 902 6341
douglas.streatfeild-james@burges-salmon.com

Jim Aveline
Succession and asset protection
+44 (0) 117 939 2283
jim.aveline@burges-salmon.com

Our Family Business team

Burges Salmon are unusual in being a leading commercial firm that also specialise in private client issues. We combine our business and family expertise to advise family businesses of all sizes through our specialist Family Business team - a group of experienced advisers dedicated to advising family businesses of all sizes across range of sectors.

One Glass Wharf
Bristol BS2 0ZX
Tel: +44 (0) 117 939 2000
Fax: +44 (0) 117 902 4400

6 New Street Square
London EC4A 3BF
Tel: +44 (0)20 7685 1200
Fax: +44 (0)20 7980 4966

www.burges-salmon.com

To receive your own regular copy of Family Business email marketing@burges-salmon.com

BURGES SALMON