Business loan protection:

Could you repay your business' debts tomorrow?

Good risk management for a business includes planning for events which might seem unlikely today but which would have a huge impact on the business.

Yet a recent report by Legal & General shows that 35% to 48% of UK SMEs do not have adequate cover to protect their debts in the case of death of a shareholding director.

For the remainder, the SMEs with business loan cover, 89% had taken advice from a financial planner or a bank. This indicates that once business owners are made aware of the risks to them and the business, they take action.

Here we explain why business loan and key person protection plans should form part of a company's risk management plan.

What are the risks to the business?

There are instances where a death, usually that of a shareholding director, will trigger the repayment of debt. If the company does not have the capital available to repay the loan it can mean serious problems.

To aggravate the situation, for the majority of SMEs those same shareholding directors are also key people.

Briefing note: Business loan protection

Losing a key person may lead to potential loss of revenue. Additionally, it may bring about costs such as recruiting an equally senior replacement, legal fees and so on.

Lower revenue and unexpected costs may leave the company also unable to service ongoing debt.

Putting families at risk

Many businesses started off with a personal loan from the founding director(s). Using this form of loan can be a real opportunity for growth and income tax planning but, like any liability, can also land a business in trouble.

Typically, one condition of these loans is that they are to be repaid to the lender's estate on their death.

This is generally also the case for director's loan accounts, where the 'loan' has arisen from salary, drawings and dividends not being taken.

In either case it should not be forgotten that if the business cannot repay these loans to the deceased's estate, the bereaved family may suffer financially.

Bank borrowing and personal guarantees

It is often the case that banks, especially for larger loans, will insist on insuring the lives of the shareholding directors. They might also require personal guarantees, secured on personal assets. This is often the family home which would be put at risk if the company is unable to repay its debts.

Peace of mind, good business planning

Simple life assurance on the shareholding director's life could cover unexpected debt repayment, protecting both the company and the director's estate.

The appropriate level of cover will depend on the amount to be repaid. If the director is also a key person, which may affect revenue, overdrafts and other serviceable debt should be taken into account too.

Where directors have provided personal guarantees to the lender secured against their assets, on a joint or several liability basis, it may be more appropriate to cover each key person for the full debt amount. This would avoid disadvantaging the business owner's dependants.
Critical Illness and Terminal Illness cover can also to the policy. The benefit will become payable on diagnosis of a serious illness from those covered by the insurer. It is more commonly used where the shareholding director is also a key person and insures against them becoming unable to work due to illness.

Business loan cover

The company would normally apply for the cover, with the life(s) assured being the shareholding director(s).

The sum assured would be at least equal to the amount to be repaid to their estate on their death.

Two directors

Where there are only two directors in a company, they may want to consider two 'life of another' policies. The company takes out two policies on the lives of each director allowing it to repay any personal or loan accounts and bank loans on the death of one, or both, directors.

Life insurance in trust

For larger companies, and where all shareholders are key, an alternative approach is for each director to take a life insurance policy and place it in a business trust for the benefit of the other co-directors.

In the event of a claim the trustees could lend funds to the business or retain them if the company's financial needs were lower than originally anticipated.

As this route involves setting up a trust, it is more complex arrangement but does give the company greater flexibility.

Taxation

Life insurance and critical illness benefits are not taxable as a trading receipt, nor will they usually trigger any Capital Gains or Inheritable Tax liability for the deceased's estate.

Premiums can be paid by the company, but as loan protection doesn't compensate for loss of profits, it's highly unlikely premiums will be tax deductible.

However, in all cases the local tax inspector should be consulted. Where the company is thinking of insuring against loss of profits, loan protection and key person cover, separate policies should normally be considered.

Cost

For the peace of mind, it gives your business, the cost of life assurance can be relatively low.

For example, a male or female director aged 40, non-smoker, with no serious medical conditions, might expect to pay £5 per month for 10 years of cover with a sum assured of £100,000. With Critical Illness Cover the cost will be in the region of £23 per month.

The cost will depend on the type, benefit and term of cover (with critical illness being more expensive), and will be subject to underwriting.

Summary

The death or serious illness of a shareholding director is a loss to the business and traumatic for their dependants, but it needn't cause financial hardship to either.

With careful planning, and as part of wider risk management, you can protect your business with relatively low cost and straightforward life and critical illness cover.

How we can help

We can guide you through what protection suits you and your business, and source the most appropriate and cost-efficient policies.

An initial phone conversation is free of charge. It will be a chance to discuss you and your business, and then decide on next steps.

To contact us, do not hesitate to call on 0207 287 2225 or by email (hello@edisonwm.com).

You can view a copy of the Briefing Note on the Insights page on our website.

Important Information

The above is a simplification of the legislation. It does not constitute advice. The views expressed above are subject to changes in legislation. The Financial Conduct Authority does not regulate tax advice.

Ref. L&Gs State of the nation's SMEs report (fifth edition)

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