

Frequently Asked Questions: Shareholder & Partnership Protection

Introduction

This factsheet provides answers to many of the most frequently asked questions relating to shareholder and partnership protection cover.

What is the purpose of this cover?

If a shareholding director or business partner dies, their business interests usually pass into their estate. Shareholder or partnership protection cover provides funds that can be used, by the surviving directors/ partners, to purchase these interests from the estate. This allows a business to continue, after a director or partner's death, without the financial strain of raising significant funds for the purchase. It also ensures that the deceased's family are not left with an unwanted share in the business.

What type of policy should be used?

A term assurance policy is ideally suited for this type of protection due to its cost. The policy could be life cover only or, where there is also a need to cover the impact of a serious illness, life or earlier critical illness cover.

How do you calculate the amount of cover?

The sum assured under a shareholder or partnership protection policy should reflect the value of the partner or director's interest in the business. This would need to be regularly reviewed to take account of any changes in this value.

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How would the policy be set up?

If the business is adopting either a cross option or buy and sell arrangement for the purchase of a business interest, each shareholding director or partner would take out a policy on their own life. Each policy should be written under a suitable trust (often called a business trust - see "What are the features of a business trust?" below) for the benefit of their co-directors/co-partners.

If partners are using the automatic accrual method, each partner would be expected to take out and maintain a term assurance policy, written under trust for the benefit of their family (as recompense for not inheriting the business assets).

Can a discretionary trust be used?

A typical life office discretionary trust is not appropriate for use in shareholder or partnership protection planning. This form of trust is designed for personal cover and allows an individual to place a life policy under trust, normally for the benefit of their spouse/civil partner or other close family members. The payment of any benefit is left entirely to the trustees' discretion.

What are the features of a business trust?

A business trust is the form of trust that is suitable for shareholder and partnership protection. Such a trust does not include the settlor's spouse/civil partner as potential beneficiaries to ensure that the planning is seen as a commercial arrangement. The beneficiaries would be either the settlor's co-shareholding directors or co-partners, as appropriate. Any new shareholding directors/partners would usually be automatically included as trust beneficiaries.

Whilst it is possible to include the settlor as a potential beneficiary of the trust, and for this not to be treated as a 'gift with reservation' for inheritance tax purposes (being part of a commercial arrangement), this could have adverse consequences with regard to pre-owned assets taxation (see "What about tax?" on page 3 of this document).

Can an existing policy be used?

It is possible to assign an existing life policy into a business trust but this is usually not to be recommended. If each shareholding director/partner makes such an assignment, HM Revenue & Customs may treat the arrangement as a reciprocal transaction and the trustees could become liable to capital gains tax on payment of the sum assured.

What is automatic accrual?

This is a method, used by some partnerships, that allows for a deceased partner's share in the business to pass automatically to the surviving partners.

What is a double option agreement?

A double option (also widely known as a cross option) agreement is a method used to facilitate the purchase and sale of a deceased shareholding director's or partner's share in the business. Within a set period after death, the estate has an option to require the surviving directors/partners to purchase the estate's share in the business. The directors/partners also have an option to require the estate to sell them the business share. If either party exercises its option, the other party must comply. Such a structure ensures that any eligibility to inheritance tax business property relief is not lost.

What is a single option?

Where critical illness cover is included, a business owner would be able to leave the business if they become seriously ill. A single option agreement gives a disabled/ill individual the option to require their co-owners to purchase the disabled/ill person's share in the business. The co-owners have no option to force the sale of a disabled/ill owner's business interests. A single option wording is often incorporated within a double option agreement.

What is a buy and sell agreement?

This is a legal agreement that shareholding directors or partners can make to ensure that, on death, their share in the business is definitely purchased from their estate by the surviving directors/partners. It is a much less popular method than the double (or cross) option arrangement, partly due to the inability to obtain inheritance tax business property relief on a deceased's business share.

What about tax?

Income tax

A director/partner would normally pay the life policy premiums from their post-tax income. If the business pays the premiums, this would be taxable in the hands of the director/partner as if it were additional remuneration.

Any policy proceeds from a qualifying term assurance policy will be free from any income tax liability.

There is a possibility of a pre-owned assets tax charge but only where the settlor is included as a potential trust beneficiary and is in very poor health at the time of any annual review for that tax.

Inheritance tax

Provided HM Revenue & Customs accept that the trust is part of a commercial arrangement favourable inheritance tax treatment (see "What is a commercial arrangement?" on the right of this page), the policy premiums will be exempt from inheritance tax and any policy proceeds will not form part of the deceased's estate.

It is possible that there could be a tax charge, under the relevant property trust regime, on each tenth anniversary of the trust. This is extremely unlikely and could only occur where the life assured was in very poor health at the time of a ten-year trust review.

The availability of business property relief will be lost if a buy and sell method is used (see "What is a buy and sell agreement?" on page 2 of this document).

If the settlor is included as a potential beneficiary of the trust, this will not be treated as a 'gift with reservation' where the planning is a commercial arrangement (see "What is a commercial arrangement?" on the right of this page).

Capital gains tax

Complications may arise if an existing life policy is assigned into a business trust (see "Can an existing policy be used?" on page 2 of this document)

What is a commercial arrangement?

If a business protection arrangement is commercial in nature it will benefit from favourable inheritance tax treatment (see "Inheritance Tax" on the left of this page). It can be commercial where there is no element of gifting and all business owners participate. Additionally, the owner's spouse/civil partner or family must not be capable of benefiting from the trust. It is also important that all new business owners join the arrangement.

Important Information

This factsheet is based upon our understanding of current tax and other legislation at the release date and may be subject to change in the future. Whilst every care has been taken to ensure the accuracy of this information, Friends Life can accept no responsibility for any actions taken as a result of this release.

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