Equalisation of policy payments

If a partner or shareholder dies, will the remaining partners or shareholders have the necessary funds to buy their interest in the partnership or their shareholding? Here we look at how to maintain the commerciality of partnership or share protection arrangements.

This information is based on our understanding of current taxation law and HM Revenue & Customs (HMRC) practice, which may change. The value of any tax relief depends on the individual circumstances of your client.

One way to make sure they do have the necessary funds is for each partner or shareholder to take out a life protection policy that runs to their retirement date. These policies could be placed in a business protection trust for the benefit of the other partners or shareholders. To make sure that they can buy the deceased partner or shareholders' interest, and keep any business property relief, they could put an agreement in place.

As the partners or shareholders will usually be of different ages, the cost of the life protection policies will vary. To maintain the commerciality of the arrangement, they'll need to equalise the policy payments so that no one pays or benefits more than they should. They could do this by making payments between themselves. This makes sure that each partner or shareholder contributes to the total cost of the arrangement in proportion to the benefits they're likely to receive and helps to protect the inheritance tax (IHT) benefits of the business trusts.

How to equalise the policy payments

The formula below assumes that each shareholder or partner will buy the deceased's business interest in proportion to their existing share of the business. You can extend this formula for any number of shareholders or partners.

What business owner A should pay =

$$\left(\frac{\text{(Business owner }\textbf{A's}\text{ share of the business }\textbf{x}\text{ business owner }\textbf{B's}\text{ policy payments)}}{\text{(Total value of the business – business owner }\textbf{B's}\text{ share of the business)}}\right) + \left(\frac{\text{(Business owner }\textbf{A's}\text{ share of the business }\textbf{x}\text{ business owner }\textbf{C's}\text{ policy payments)}}{\text{(Total value of the business – business owner }\textbf{C's}\text{ share of the business)}}\right)$$

What business owner B should pay =

$$\left(\frac{\text{(Business owner }\textbf{B's}\text{ share of the business }\textbf{x}\text{ business owner }\textbf{A's}\text{ policy payments)}}{\text{(Total value of the business – business owner }\textbf{A's}\text{ share of the business)}}\right) + \left(\frac{\text{(Business owner }\textbf{B's}\text{ share of the business x business owner }\textbf{C's}\text{ policy payments)}}{\text{(Total value of the business – business owner }\textbf{C's}\text{ share of the business)}}\right)$$

What business owner C should pay =

$$\left(\frac{\text{(Business owner }\textbf{C's}\text{ share of the business }\textbf{x}\text{ business owner }\textbf{A's}\text{ policy payments)}}{\text{(Total value of the business – business owner }\textbf{A's}\text{ share of the business)}}\right) + \left(\frac{\text{(Business owner }\textbf{C's}\text{ share of the business }\textbf{x}\text{ business owner }\textbf{B's}\text{ policy payments)}}{\text{(Total value of the business – business owner }\textbf{B's}\text{ share of the business)}}\right)$$

Example

Smith & Jones Plumbers Ltd
Total share value: **£500,000**
Directors' retirement age: **65**

Directors:
John Smith, age 55, shareholding 40%
Fred Smith, age 50, shareholding 35%
Bert Jones, age 45, shareholding 25%

The policies	John Smith	Fred Smith	Bert Jones
Policy years	10	15	20
Benefit amount	£200,000	£175,000	£125,000
In trust for the benefit of	Fred Smith & Bert Jones	John Smith & Bert Jones	John Smith & Fred Smith
Yearly policy payments	£1,062	£772	£384

Using the formula on the previous page, they'd equalise the policy payments as follows:

John Smith

$$\left(\frac{200{,}000 \times 772}{500{,}000 - 175{,}000}\right) + \left(\frac{200{,}000 \times 384}{500{,}000 - 125{,}000}\right) \quad £475.08 + £204.80 = £679.88$$

Fred Smith

$$\left(\frac{175{,}000 \times 1{,}062}{500{,}000 - 200{,}000}\right) + \left(\frac{175{,}000 \times 384}{500{,}000 - 125{,}000}\right) \quad £619.50 + £179.20 = £798.70$$

Bert Jones

$$\left(\frac{125{,}000 \times 1{,}062}{500{,}000 - 200{,}000}\right) + \left(\frac{125{,}000 \times 772}{500{,}000 - 175{,}000}\right) \quad £442.50 + £296.92 = £739.42$$

Total policy payments = £2,218.00

Use our premium equalisation calculator to help maintain the commerciality of any succession planning arrangements using a business trust.

The effect of equalising the policy payments

	Actual cost	Equalised cost	Difference
John Smith	£1,062	£679.88	+ £382.12
Fred Smith	£772	£798.70	– £26.70
Bert Jones	£384	£739.42	– £355.42
Total	£2,218	£2,218	£0

Bert Jones and Fred Smith would pay £355.42 and £26.70 respectively to John Smith. In practice, this would usually be done by adjusting the partners' capital accounts or the directors' loan accounts, rather than by paying cash to each other.

These are transfers of value for IHT purposes, but they'll usually be covered by either the small gifts exemption of £250 or the yearly exemption of £3,000. It could also be claimed that they're exempt as a genuine business expense.

The calculation for equalising partners' policy payments will be the same, except it will be based on each partner's interest in the partnership rather than their shareholdings.

Frequently asked questions

What happens if the partnership makes the policy payments?

It doesn't matter if the policy payments are made from the partnerships' bank account or by the partners directly – the result is the same. The policy payments should be equalised in both cases.

What happens if the company makes the policy payments but charges the cost to the directors?

As the directors have been charged with the cost, this isn't a benefit in kind so the equalisation calculation is the same.

What happens if the company makes the policy payments?

If a limited company makes the policy payments on behalf of the shareholder directors, there's no need to equalise them as there hasn't been any cost to the directors. However, the shareholder directors will have to pay income tax and National Insurance (NI) on the value of the policy payments the company makes.

In addition, the company will have to make employers' NI contributions. This will be based on the unequalised policy payments so there could be a difference in the cost to each director that needs to be equalised.

Example

Let's assume that Smith & Jones Plumbers Ltd, from the earlier example, meets the cost of the total policy payments of £2,218, and that all shareholders are UK higher rate taxpayers who make NI contributions of 2% on the benefits. Using the formula, the equalised policy payments would be:

	Income tax and NI (42%)	Equalised cost	Difference
John Smith	£769	£492.27	+ £276.73
Fred Smith	£559	£578.31	– £19.31
Bert Jones	£278	£535.42	– £257.42
Total	£1,606	£1,606	£0

The company would usually be able to claim a corporation tax deduction for providing the benefit and making any employer's NI contributions.

What if the partners or shareholders don't want to equalise the policy payments?

For IHT purposes, it's very important to maintain the commerciality of the arrangement. If each partner or shareholder doesn't equalise the policy payments for the arrangement, it could be argued that it's not commercial. This could jeopardise the IHT-effectiveness of the business protection trusts used.

If you need any help with this, please speak to your usual Aegon sales representative.

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