Business Protection

Own life policy held under a business trust

The owners of a business will want to make sure that their business can continue if they die or become critically ill, whether they're:

- a shareholder of a company;
- a partner in a partnership, or
- a member of a limited liability partnership (LLP).

For the purpose of this factsheet, an outgoing owner is an owner who has died or become critically ill.

When an owner dies, their share in the business will pass to their beneficiaries – most likely their family members – under the terms of their will or according to the law of intestacy if they don't have one. But this might not be what either the continuing owners of the business or the outgoing owner's family wants to happen.

The continuing owners might want to buy the outgoing owner's share. And the outgoing owner's family, who might not have been involved in the business, might prefer the cash value of the share.

A problem arises where the continuing owners don't have the funds to buy the outgoing owner's share. Life protection policies can be used in different ways to provide solutions to this problem.

Here, we'll look at the own life protection policy under business trust method – how this is arranged and the tax issues you need to consider.

Trusts establish legal rights and entitlements and might have material financial and tax implications for the settlor, trustees and beneficiaries. We aren't authorised to provide legal advice, so anyone setting up a trust would have to take their own legal advice, to make sure that it meets their requirements. Our trusts have been drafted for use by UK domiciled individuals.

It's important that you check that any agreement that deals with what's to happen to a business owner's share when they die or become critically ill is allowed under the partnership agreement or articles of association. Otherwise you might need to change the agreement.

For smaller numbers of owners, a life of another arrangement – which doesn't need a trust – might be more suitable. This factsheet doesn't cover this method.

How the arrangement works

Each individual owner takes out a life protection policy on their own life, which will generally run up to their retirement date.

The benefit amount should reflect the value of their share in the business.

Each owner's policy is held in a business trust from the start, for the benefit of each of the other owners. Policies taken out by entities other than individuals - such as a company - or written on any basis other than their own life - shouldn't be held in our business trust.

When an owner dies or becomes critically ill, the claim proceeds are paid to the trustees. This keeps them outside their estate. The continuing owners can use this cash to buy the outgoing owner's share of the business.

While this arrangement provides the funds to buy the outgoing owner's share, there also needs to be an agreement that this is what the continuing owners will use these funds for.

Option agreements

We have two sample option agreements that you can use. One that can be used for life protection and one for critical illness protection.

For life protection, we have a sample double option agreement (or cross option agreement). When an owner dies, the continuing owners have an option to buy their share and the outgoing owner's personal representatives have the option to sell their share. If either party chooses to use their option, the other party must comply.

For critical illness protection, we have a sample single option agreement. With this type of agreement, only the critically ill owner can apply the option to sell their share – they can't be forced to sell their share by the continuing owners. This is largely to protect the critcally ill owner, particularly if it's likely that they'll recover and return to work.

All the owners should participate in the option agreement arrangements. While we have sample option agreements, the owners could choose to use a buy and sell agreement instead. However a buy and sell agreement would result in the loss of any business property relief (BPR) on the outgoing owner's share. A share in a business might not be liable for inheritance tax (IHT) if it meets the BPR qualifying conditions, making it a valuable tax relief. BPR isn't available where property – such as a share in a business – is subject to a binding contract for sale.

While this type of protection arrangement won't influence the BPR that the share attracts, it's important to make sure that any protection arrangement set up won't jeopardise a claim for BPR.

Making policy payments and the tax implications

For companies

Now that the arrangement to protect the business and its owners is in place, you need to consider who's going to pay for the policy and the tax implications.

Where the interest is a shareholding in a company, the policy payments can be made by any of the following:

- the company;
- the company who then charges the cost to the owners, or
- the owners themselves.

We'll now consider the tax implications of each in turn.

This information is based on our understanding of current taxation law and HM Revenue and Customs (HMRC) practice, which may change.

The company

If the company makes the policy payments, it will receive tax relief as long as the payments meet the 'wholly and exclusively for the purpose of the business' test. In other words, the shareholders' total remuneration, including these payments, shouldn't be excessive in relation to the duties they perform for the company. It effectively gets a deduction for the policy payments made, along with any employer National Insurance (NI) contributions due, at the company's tax rate.

As the company is providing additional remuneration to an employee, the employee will pay tax on it.

Company charging the cost to the owners

If the company charges the cost to the owners then tax relief won't be available on the policy payments.

Owners

The owners might decide to make the policy payments themselves – perhaps out of salary and/or dividends received from the company. In this instance, no tax relief is available on the policy payments.

For partnerships and LLPs

If the business is a partnership or an LLP it doesn't matter if the policy payments are made from the partnership or LLP's bank account or by the owners directly. Either way they won't attract tax relief. Ultimately the policy payments will be deducted from the owner's capital account.

Equalising the policy payments

As each owner applies for a life protection policy on their own life, the policy payments will vary depending on their age. The cost of a policy for an older owner will generally be higher than for a younger owner, but they'll be less likely to benefit from the arrangement. The younger owners have a higher chance of increasing their interest if an older owner dies or becomes critically ill. You can address this inequality by equalising the policy payments.

For IHT purposes, it's very important that you maintain the commerciality of the arrangement. If each owner pays different amounts for their life protection policies, it could be argued that the arrangement isn't commercial – jeopardising the IHT effectiveness of the business trusts.

You can read more about this and how to do it in our Equalisation of policy payments factsheet.

Business trust – IHT considerations

There are also IHT implications with the business trust that you need to consider.

Settlor makes the policy payments

Our business trust is an interest in possession trust. If it's been created after 21 March 2006, the trust is subject to the discretionary trust IHT regime. Usually, if the policy payments are made by the person who set the trust up (the settlor), they'd be treated as a gift for IHT purposes. This gift would be a chargeable lifetime transfer. However the policy payments will usually be exempt transfers – in other words free of IHT implications – as long as it's a commercial arrangement. If the policy payments aren't exempt transfers, an IHT charge known as an entry charge might be payable if the total amount of the settlor's chargeable lifetime transfers in the last seven years is more than their available IHT threshold.

As well as considering the IHT implications of the policy payments, an interest in possession trust created after 21 March 2006 is potentially subject to 10-yearly and exit charges.

Paying claim proceeds to trustees

A term policy won't usually have a surrender value until a claim is made. When the insured person dies or becomes critically ill, we'll pay the claim proceeds to the trustees. This won't, in itself, trigger a tax charge, but a 10-yearly charge might be payable if the claim proceeds are paid into trust just before a 10-year anniversary or are sitting in the trust at this time. In practice the possibility of IHT becoming due on a 10-yearly charge is small.

You also need to consider the possibility of an exit charge when the trustees pay the claim proceeds to the continuing owners so that they can buy the outgoing owner's share. As with the 10-yearly charge, the possibility of an exit charge is small.

Business trust – other tax considerations

While we've considered the IHT implications of using the business trust, there are other tax considerations.

Paying claim proceeds to trustees – capital gains tax (CGT)

As the business owner needs to take out a life protection policy held under a business trust from the start, an existing policy can't be transferred (assigned) into our business trust. This is because the transfer of an existing policy would make the policy second-hand, so any claim proceeds could be liable for CGT. Trustees pay CGT at 20% on gains above the yearly exemption (£6,000 for 2019/20). This means that not all of the proceeds would be available to buy the outgoing owner's share.

Pre-owned assets tax (POAT) – income tax

A business owner who takes out a policy and places it under a business trust is the settlor of that trust. Usually if someone gives an asset away, but they can still benefit from the gifted asset, it's treated as a gift with reservation (GWR) of benefit. To avoid the GWR provisions applying, it's important that the arrangement is commercial. An owner is only placing their policy in trust for the other owners because they're doing the same. So only the owners participating in the arrangement can benefit.

If the settlor's family members were possible beneficiaries of the trust, the commerciality of the arrangement would be ruined. This is why our Flexible Trust isn't suitable for this type of arrangement.

The settlor is a potential beneficiary of the trust because the trustees can transfer or appoint the trust fund to the settlor in certain circumstances. Consequently, this arrangement – while avoiding the GWR provisions – is caught by POAT. As the policy will generally have no value, the possibility of an income tax charge being payable is small.

Chargeable event legislation

A claim when the insured person dies is a chargeable event occasion. However the chargeable event calculation is based on the policy's surrender value immediately before death, less the policy payments made. It isn't based on the actual proceeds paid out. A term policy won't normally have a surrender value and therefore a chargeable event gain shouldn't occur when the insured person dies. An income tax charge shouldn't occur due to a critical illness benefit being paid.

Key points

- An arrangement using life protection policies can help make sure that if an owner dies or becomes critically ill, the business can continue and their family will receive the cash value of their share.
- It's important to consider all of the tax issues to make sure that the arrangement is tax efficient.

If you need any help with this, please speak to your usual Aegon sales representative or visit our website for more business protection support.

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IP00273868 04/19