Taxation of policy proceeds - cover on shareholding directors

Synopsis: Taxation of the sum assured - personal and corporate policies

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The policy proceeds should not be assessed to tax regardless of how the policy is written (that is, a company-owned policy on the life of the director or a personal policy in trust for co-directors) although HMRC makes it clear that the tax treatment of the receipt of the proceeds is a separate matter and there is no assurance that proceeds will not be taxable even if the premiums are not allowable – please see below.

The purpose of effecting the policy is also important and will be considered by HMRC in each case. It is the ascertained purpose at the time of effecting the policy, rather than when the benefits are received and actually used, that is important.

In any event, if proceeds are received by the company, then if the owners (i.e. the other shareholding directors) wish to extract the funds for their own benefit, there will be a tax price to pay if the payment is by way of salary, bonus or dividend (i.e. the payment will be assessable on the shareholder receiving it).

Where proceeds are paid to trustees of personal policies for the benefit of the co-shareholders, no tax will be payable on receipt of the proceeds by the other shareholders.

Personal policy

The policy proceeds will not be subject to income tax and as the policy will be a protection policy with no surrender value there will be no chargeable event gain to tax. Clearly, while this will be the case in most situations the outcome in practice will depend on the facts.

If an existing policy was made subject to trust as part of business arrangements, it could be argued that the assignment into trust was for consideration (i.e. in return for the other directors assigning their policies into similar trusts for each other's benefit), which could mean that the proceeds of the policy could be subject to capital gains tax. There is, however, an argument that the new owners (i.e. the trustees) did not provide the consideration. To be safe on this, however, only newly proposed policies should be used in business arrangements.

Corporate policies

Generally speaking, the proceeds should not be subject to corporation tax as a trading receipt if the premiums have not been deductible but there is no absolute certainty on this issue.

The case of Greycon Ltd –v- Klaentschi, heard before a Special Commissioner in 2003, gives an example of the problems that can arise and highlights the importance of keeping evidence of the purpose of the policy at the time the policy is effected.

The facts

Greycon Ltd, a small close company, provided special computer services to the paper industry. Another company, TR, wished to take an interest in Greycon and agreed to guarantee Greycon´s business indebtedness, to the tune of £150,000, for two years, effectively providing two years´ working capital. In addition, as part of the agreement, TR had a two year option to purchase 20% of the shares of Greycon and should this option be exercised the other shareholders in Greycon could exercise a five year put option requiring TR to acquire the balance of the shares in Greycon.

A pre-condition of the agreement was that Greycon put in place keyperson cover, acceptable to TR, on the life of the younger of the two founding shareholders who were also the *"brains of the business"* – this shareholder was Dr Goulimis. A five year term assurance for a sum assured of £499,999 was effected, mistakenly with Dr Goulimis as the grantee. However, this did not matter as a year later Dr Goulimis was called up for military service in Greece which meant that the policy was invalidated.

Replacement cover, effected by Greycon, was put in place on the life of Mr Dimitriadis (another keyperson) and comprised of five whole of life assurance policies with a combined sum assured of £499,999. Although there would appear to have been no obligation to replace the policy that had been invalidated, the replacement policies had been effected to honour the pre-condition set by TR. Three years later an additional policy, written on the same basis as the other five, was taken for a sum assured of £86,000.

Tax relief was erroneously claimed on the premiums (the lives assured being significant shareholders and directors) and the position was rectified in 1997. Unfortunately, Mr Dimitriadis died in 1999 and policy proceeds totalling £585,999 were paid to Greycon. HMRC sought to tax the proceeds as a trading receipt and Greycon argued that the proceeds were capital and therefore not subject to tax.

The Special Commissioner had to decide whether the policy proceeds were of a revenue or capital nature and whether they were a receipt of Greycon´s trade.

The arguments

It was argued for Greycon that TR regarded Dr Goulimis as the vital keyperson because he had developed the software and the success of Greycon depended on the software being further developed. Therefore, TR had a need to protect its investment in the form of the bank guarantee for £150,000 and possible future investment in 20% of the shares (initially these would have cost £150,000, sufficient for Greycon to repay the bank loan). In addition, TR could have been called upon to purchase the 80% remaining shares which it did not already own. Greycon took the policy to secure a source of capital and to provide a possible exit for its shareholders. The purpose of the loan was to fund the purchase of new offices for Greycon which was a capital purpose.

It was further argued that whereas profits for the previous accounting period were about £23,000, life cover was about £500,000; there was no element of accident cover in the policies which indicated they were not taken in connection with trading profits; and TR did not have the necessary insurable interest to effect life cover for its own benefit.

HMRC argued that Dr Goulimis and Mr Dimitriadis were both keypersons (the original proposal for the policy on Dr Goulimis´ life showed that 50% of profits were attributable to him and 33% to Mr Dimitriadis). Mr Dimitriadis´ value to Greycon increased substantially when Dr Goulimis had to go to Greece. It was pointed out that the agreement did not state the purpose for taking out the original policy and that the effect of the agreement was to guarantee Greycon´s *"ordinary course of business indebtedness".*

In addition, there was no evidence that capital assets were purchased and there was nothing in the agreement which required the replacement policies to be effected.

Given the lack of concrete evidence of the reason for the cover originally, HMRC argued that the purpose of the policy *"was to fill the hole of the trading loss that would accrue on the death of Mr Dimitriadis, by providing funds with which equivalent expertise could be purchased in order to enable the appellant´s (Greycon´s) trade to continue, rather than any capital loss on the shares or loan".*

HMRC relied on the House of Lords´ decision in Williams´ Executors. In this case the life of a keyperson was insured because on his death *"the company´s business would suffer and his family would not get much for his shares".*

The House of Lords overturned the decision of the Special Commissioners because the Master of the Rolls *"accepted that there was a loss in value of the shares held by the shareholders who were also directors, but determined in the light of the circumstances that the real object of the insurance was to make up the trading loss to the company".*

Reasons for the decision

The Special Commissioner, in deciding in favour of Greycon, stated that both sides agreed that the purpose of the cover had to be established at the time the policies were effected.

HMRC contended that in any case where a company insured the life of a keyperson, the effect is to cover a loss of profits on that person´s death. Also, in support of HMRC´s case, the moneys received by way of bank loan were principally spent on rent, which is a revenue expense, and there were no significant assets added to the balance sheet at the time of the agreement with TR.

For Greycon it was argued that the policy was taken to satisfy a condition precedent for the agreement of TR. TR needed the cover to protect its investment. For example, on the death of Dr Goulimis it could have loss £150,000 on the loan guarantee, or 20% of the share capital or the whole of the share capital, depending on circumstances, which could have exceeded £500,000.

The position was exacerbated when Dr Goulimis went to Greece and so cover was continued on Mr Dimitriadis´ life.

The Special Commissioner agreed that the policies would fill the hole in profits on the death of a keyperson (Mr Dimitriadis) and this must have been at least a purpose in taking the policies.

The HMRC argument would have been stronger had Greycon decided to take out the policy on Dr Goulimis´ life. But instead Greycon took the policy to obtain the funding and other benefits of the agreement with TR. The Special Commissioner found that Greycon *"had a capital purpose in taking out the original and substituted policies"* and allowed the appeal the consequence of which was that the policy proceeds were not part of Greycon´s trading profits.

The case seems to have been finely balanced. Had HMRC won, Greycon would have obtained no tax relief on the premiums and been assessed to tax on the policy proceeds.

In this connection, it is important to note that the statement made by Sir John Anderson in the House of Commons in 1944, which still forms the basis for the deductibility of premiums, makes no reference to the tax treatment of policy proceeds. It is generally understood that if tax relief is not available on the premiums as a revenue expense, the proceeds would be treated as a receipt on capital account and so not be subject to tax (this is on the basis that the company was and remained the original beneficial owner of the policy).

HMRC's Business Income Manual states, at BIM45525 - Specific deductions: insurance: employees and other key persons...

"As a general rule, where a policy does not comply with all the above conditions:

- *the premiums cannot be deducted, and*
- *receipts under that policy are not taxed as trading income.*

However, whether particular receipts are part of trading income is a separate matter of law to the deductibility of expenditure. No assurance can be given that any future receipt will be excluded from trading income even though the premiums are not allowable (Simpson v John Reynolds & Co (Insurances) Ltd [1975] 49 TC 693 and McGowan v Brown & Cousins [1977] 52 TC 8).

General guidance on insurance receipts is at BIM40750 onwards."

It must be borne in mind that when premiums are deductible it is not possible to forgo claiming the deduction in the expectation that the policy proceeds will escape tax by being treated as a receipt on capital account.

It is recommended that if there is any doubt as to deductibility of premiums confirmation is sought from HMRC. It is unlikely HMRC will give a view as to the likely tax treatment of policy proceeds as this will depend on all of the circumstances as illustrated by the Greycon case. It is also recommended that the precise reason(s) for effecting the cover is minuted to be later used in evidence if required.

Taxation of gains on the company – death benefits

As a separate issue to the taxation of the policy proceeds it is necessary to determine whether any tax liability arises on any chargeable event gains under the life policy chargeable event legislation. Obviously this is only relevant where the policy has an investment element (e.g. whole of life) as policies providing pure life cover will not give rise to chargeable event gains.

For life policies, gains accruing prior to the company's first accounting period beginning on or after 1 April 2008 are subject to the chargeable event rules; gains arising after that date are subject to the loan relationship rules

For corporate policies the loan relationship rules will not apply to policies only providing death benefits or critical illness cover because the loan relationship rules only apply *"to a policy of life insurance which has, or is capable of acquiring a surrender value".* It is unlikely that a keyperson policy will acquire a surrender value.

Taxation of gains on the company - critical illness benefits

Payment of a lump sum benefit on critical illness or other disability is not a relevant capital payment which means that no chargeable event gain will ever arise in respect of such a payment. It is unlikely the policy will acquire a surrender value so as to fall to be taxed under the loan relationship rules.

As far as assessability of proceeds to corporation tax is concerned, the same issues will be relevant to critical illness policies, as to life policies, as discussed above.

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