Funding the purchase of company shares or a share in a partnership - life policies, etc.

Synopsis: Choice of life policy to fund the purchase of company shares or a share in a partnership.

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Life assurance policies (incorporating critical illness cover where appropriate) will normally provide the most practical and economic method of providing the funds to make a purchase of the shares, or partnership share, of the deceased or critically ill shareholding director/partner. There are three ways of effecting policies: on a life of another basis; on a joint life first death basis; or on an own life basis subject to a business trust.

In all cases, the potential impact of capital gains tax (CGT), after any business asset disposal relief (previously known as entrepreneurs' relief), should be taken into account in ascertaining the required cover level. This factor will usually be more important when considering critical illness cover as there would have been no prior revaluation of the shares/partnership assets as on the holder's death.

Life of another, joint life first death or trust policy?

In simple, two-shareholder/two-partner partnership, cases, the life of another route may look attractive. It certainly has the merit of ensuring that if there is any disparity in the cost of cover, the party most likely to benefit (i.e. the younger shareholding director/partner) will bear the greater cost. They will be paying the premiums under the policy on the life of the older shareholding director/partner or the director/partner with the greater shareholding/partnership share.

However, the life of another route becomes relatively cumbersome once the original use of the policy ceases, e.g. if a director/partner disposes of their shares/partnership share otherwise than on death. Each director/partner would then have a policy on the life of the other one when the purpose of the policy has ceased. If the policies were to be continued, say for the benefit of the life assured or their family, then assignment of the policies to the original life assured or to trustees of a trust for the benefit of family beneficiaries would have to be arranged.

In these circumstances, each director/partner would probably only agree to assign their policy if the remaining shareholding director/partner assigned their policy in return. Each policy would then be in the hands of other than the original beneficial owner and this person may have acquired the policy for consideration in money or money's worth. HMRC may then take the view that gains made on a subsequent disposal of the policy (including payment of the sum assured on death) could be liable to CGT (section 210 TCGA 1992).

The life of another route is also very inflexible and does not easily cater for changes in circumstances, especially where there is, or is likely to be in the future, more than two shareholders partners. For this reason, the most efficient route is for each shareholding director/partner to take a policy on their own life subject to business

trusts for the benefit of their co-shareholding directors/partners. Of course, since 22 March 2006, consideration needs to be given to the discretionary trust regime when dealing with business trusts.

Occasionally, for firms with only two shareholding directors/partners and where it is certain that there will be no more shareholders/partners in the future, an economical option may be to effect one policy on a joint life first death basis. The policy is proposed for by both shareholding directors/partners on their joint lives and the death benefit is paid to the survivor on the first death. No trust will be necessary.

Care must be exercised with regard to the specific policy provisions.

Generally speaking, such a policy will be a joint asset of the owners and on the first death one half of the policy value would be included in the estate of the deceased, even though it would pass under survivorship to the other joint owner. This will have inheritance tax (IHT) consequences (unless the owners are married to each other or registered civil partners which is probably unlikely).

However, following the decision in Murphy v Murphy (2004), if the policy is pure term assurance and it provides that the only person entitled to the death benefit is the survivor then no value would be included in the estate of the deceased. On this basis – and in such limited circumstances as referred to above - this route of providing life cover may well be suitable.

Commerciality?

The need for commerciality arises because…

- it is good business practice (i.e. the parties want to pay for the true benefit they get); and
- a commercial arrangement displaces a gratuitous intent and therefore means that the IHT gift with reservation rules cannot arise.

Commerciality can be evidenced by…

- all participating individuals paying a premium commensurate with or proportionate to their likely benefit under the arrangement; and
- the payment of policy being limited to business partners (not members of the deceased's family) i.e. family members must be excluded from benefit under the trust.

New and existing policies

In most cases where share purchase arrangements are entered into, each shareholder/partner would effect a policy subject to a business trust from outset. A question may arise, however, where shareholding directors/partners have existing life cover, whether such existing policies can be assigned into a business trust.

Those operating in the business assurance market have, for some considerable time, been warned that, should cases be discovered where life assurance has been effected by partners or shareholders in the business for the purpose of providing funds for a future share purchase, or the purchase of a partnership share, on death and/or critical illness, and these policies are not held subject to business trusts, it would not be good advice to transfer these policies into business trusts as it would amount to a reciprocal arrangement between business owners.

The reason for this, to date, has been that, until the changes introduced by s157 Finance Act 2003, s210 TCGA 1992 provided that, broadly speaking, a life assurance policy would not be subject to CGT unless...

1. The policy, at the time of the chargeable disposal, was held by other than the original beneficial owner of that policy; and

2. The owner had secured their interest by way of an assignment for money or money´s worth.

It was a relatively well known HMRC view that (even though the legal owners of a policy assigned into a business trust after the time at which it was originally effected would be the trustees, and these would be the people making the disposal, who would not have given consideration in money or money´s worth for their interest) as the context of the arrangement was that one business owner conveyed their property into trust for their co-owners in return for the other co-owners doing the same for them, consideration had in effect been given.

There had always been some debate about the rightness of this contention but, broadly speaking, it seemed that business practice was to "play it safe". This meant that should, say on a policy audit for a business, it be discovered that there were existing policies in place which were not subject to trust then it would not be suggested that these policies were conveyed into trust. Instead, it would, typically, be suggested that either...

- The underwriting life office were contacted with a view to ascertaining whether they would reissue a "balance" policy without further underwriting which could be issued subject to a business trust from outset and thus not fall foul of the s210 provisions...

or

- If this were not possible then there was no choice, if one wished to avoid the possible CGT risk, but to effect new policies subject to trust from outset thus avoiding the contention that the policies had been "assigned for money or money´s worth" or "were in the ownership of other than the original beneficial owner".

At this point, it is worth noting that, if the CGT rules did apply to the policy, the effect could be disastrous. The main "disposal" for CGT in the context of a policy focused primarily on providing protection would be the payment of the sum assured. This would clearly be categorised as a disposal for CGT purposes. The bad

news for those involved is that the disposal, whilst triggered by the death of a person, would not have arisen on the death of the person making the disposal.

Of course, the person deemed to be making the disposal for CGT purposes would be a person, namely the trustees, who would be alive and so there would no revaluation on death. This could mean that a gain arising would amount to the difference between the sum assured and the consideration paid for the policy (including premiums paid subsequent to the assignment into trust). As one can appreciate, this sum could be significant.

The introduction of the new s210 TCGA a few years ago caused some to consider whether this CGT problem for existing policies assigned into trust in a business context would now no longer arise. The cause for this possible optimism was, unsurprisingly, the new words of the "offending provision".

The new s210(3) states that the exception to the rule that life assurance policies are not subject to CGT applies where at the time of disposal of the rights in the policy (e.g. payment of the sum assured) or any interest in the rights in the policy at any time have been acquired for actual consideration.

In determining whether the exception applies where existing life assurance policies are made subject to business trusts as part of an arrangement whereby each of the owners of a business (partners or directors, or limited partners) decide to transfer their interest in a policy on their own life into trust for the benefit of their co-owner, in return for each of their co-owners doing the same, it is necessary to establish...

1. Whether there has been a disposal of the rights or any interest in the rights under the policy; and
2. If there has been a disposal of an interest in the rights under the policy, have the rights or any interest in the rights at any time been acquired by any person for actual consideration.

There can be little argument that there would have been, in the circumstances envisaged, a disposal of the rights under the policy by virtue of the payment of the sum assured and, at that time, it could be said that an interest in the rights under the policy (namely the beneficial interest) had been acquired for consideration. After all, as explained above, in a typical case each business owner would have assigned their policy into a business trust only in return for their co-owners doing the same. This "reciprocal" assignment will clearly amount to consideration. However, is it "actual" consideration?

It is believed that it is, since the only "deemed" consideration that is referred to in the legislation is consideration deemed to be such for the purposes of the CGT legislation. Clearly, even though the consideration for an assignment of a policy into trust in the circumstances envisaged is not a consideration in money, it is consideration nevertheless and "actual consideration" at that.

Indeed, far from enabling policies to more readily avoid being brought into the CGT net by virtue of an assignment between business owners after the day the policy

was originally effected, the new provisions in s210(3) seem to make it even clearer that such an assignment would be "caught" referring, as they do, to the interest in rights under the policy being acquired by "any person" in the policy´s history for actual consideration.

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