

Key person and loan protection

Companies

The taxation implications for a company depend upon the solution, the type of plan chosen, the reason for the cover and the relationship between the key person and the company. However, HM Revenue and Customs will treat each case on its own merits and may take a different approach to that outlined below. It may therefore be advisable to contact the firm's local Inspector of Taxes to find out the approach they will take. A draft letter to HM Revenue and Customs is on page 28.

Life of another

There are 4 tests to see if a premium is a tax-deductible expense for the company.

These are:

- The purpose of the plan is to solely protect against loss of profit.
- The sole relationship should be employer/employee (although very small shareholdings – e.g. under employee share schemes – are likely to be ignored).
- The plan must be a short-term assurance, which is normally understood to mean a non-convertible term insurance plan with a term of no more than 5 years.
- The sum assured must be reasonable.

If the plan fails any of these tests the premium is unlikely to be tax deductible. For example, a plan taken out to provide security for a loan would not meet the requirement for it to protect solely against loss of profit. Therefore, premiums are not normally allowable for corporation tax relief and the sum assured is not normally regarded as a trading receipt.

The premium will not be assessable against the key person for income tax or national insurance as the benefits belong to the company.

If the premiums qualify for relief from corporation tax, then the sum assured, when paid, would usually be treated as a trading receipt and subject to corporation tax. Therefore, to provide a given level of cover the sum assured must be increased to cover the tax loss.

For example:

A company takes out a 5-year term assurance with a sum assured of £500,000 and premiums of £1,500 each year. The corporation tax rate is 28% therefore the net cost of premiums after relief from corporation tax would be £1,080.

In the event of a claim, the corporation tax payable, assuming a corporation tax liability in that year of 28%, would be $£500,000 \times 0.28 = £140,000$.

The original sum assured therefore needs to be increased to £694,444 to cater for the corporation tax liability.

In the past it was thought possible to reduce the impact of corporation tax by arranging the cover to be paid in instalments over a number of years. However under current Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS) requirements, it is unlikely this will be successful as the liability to tax will arise in full on claim.

It is important to note that not claiming tax relief, if the premium would have qualified, will not necessarily prevent the sum assured from being treated as a trading receipt and being taxed. Therefore, written confirmation should be obtained from the local HMRC Inspector that the premiums do not qualify as a business expense, and that the benefits will not be taxable. However, this may not always be forthcoming.

Companies – life of another continued

Key Person Income Cover for Sickness is likely to be tax deductible for the company if the plan meets the 4 tests outlined on page 21. If the benefits are used for profit protection, they are likely to be taxed as a trading receipt. If the benefits are going to be used for sick pay, they are likely to be taxed, but when paid out to the employee they would become deductible cancelling out the tax. The employee will of course be taxed on their pay as normal and would therefore continue to be subject to income tax and employee's National Insurance. Therefore, if Key Person Income Cover for Sickness is to be used for sick pay it may be better for the key person to take the plan out on his or her own life, especially as the maximum claim payment period for Key Person Income Cover for Sickness is 5 years. The company could pay the premiums, which would be taxed as a benefit in kind, but the benefit would be tax-free to the employee.

Own life in trust

If the company pays the premium it can deduct the expense for corporation tax purposes as meeting a liability of a shareholder. But it will still have to pay employer's National Insurance.

The shareholder who takes out the plan will be assessed for income tax and National Insurance on the amount of the premium. But the sum assured will pass to the trustees of the business trust free of taxation. There should not normally be any inheritance tax due as this is part of a commercial arrangement. But there could be a liability if the money received from the plan is kept within the trust past the next 10-year anniversary of the creation of the trust, and the value of the trust is more than the then nil-rate band.

If there is a positive director's loan account then premiums can be treated as a repayment of this loan, thus generating no further tax implication on that director. In this case there would be no corporation tax relief for the company.

The plan must be written under trust from commencement. It is not recommended that an existing plan is assigned into a business trust as this could give rise to a liability to capital gains tax. This is because it is possible for HM Revenue and Customs to argue that as this is part of a commercial arrangement, the plan is being disposed of by someone who is not the original beneficial owner (the trustees) and they acquired their interest for consideration. Any gain, the difference between the amount they receive following a claim and the premiums paid, would therefore be assessed for capital gains tax (Section 210 Taxation of Chargeable Gains Act 1992). This can be avoided by asking that the plan is issued under trust from the start so that the trustees are the original owners.

Partnerships and LLPs

If the life assured is a partner or member the premiums are generally treated as being payable out of the partners' or members' income after tax.

The plan must be written under trust from the start. It is not recommended that an existing plan is assigned into a business trust as this could give rise to a liability to capital gains tax. This is because it is possible for HM Revenue and Customs to argue that as this is part of a commercial arrangement, the plan is being disposed of by someone who is not the original beneficial owner (the trustees) and they acquired their interest for consideration. Any gain, the difference between the amount they receive following a claim and the premiums paid, would therefore be assessed for capital gains tax (Section 210 Taxation of Chargeable Gains Act 1992). This can be avoided by requesting that the plan is issued under trust from the start so that the trustees are the original owners.

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However, where the plan is set up as key person cover on the life of an employee of the firm, it may be possible for the partners or members to argue that the expense, if met by the partnership or limited liability partnership, is a deductible expense incurred for a revenue purpose. This depends on the plan fulfilling the 4 tests below and being on the balance sheet as a partnership or membership asset. It may also be necessary for there to be some form of commitment to make sure that the proceeds would be payable to and held as a partnership or membership asset. It may therefore be advisable for an approach to be made to the firm's local Inspector of Taxes to find out the approach they will take. Draft letters to HM Revenue and Customs are on page 28.

There are 4 tests to see if a premium is a tax-deductible expense for the partnership or limited liability partnership.

These are:

- 1 The purpose of the plan is to solely protect against loss of profit.
- 2 The sole relationship should be employer/employee.
- 3 The plan must be a short-term assurance, which is normally understood to mean a non-convertible term insurance plan with a term of no more than 5 years.
- 4 The sum assured must be reasonable.

If the plan fails any of these tests, the premium will not normally be tax-deductible for the partnership or limited liability partnership. For example, if the key person cover is taken out on a partner or member it is unlikely that tax relief on the premiums would be granted, even if all 3 other conditions were met.

Only if the premiums qualify for relief from income tax will the sum assured, when paid, usually be treated as a trading receipt and subject to income tax. Therefore, in order to provide a given level of cover, the sum assured must be increased to cover the 'tax loss'. The premium will not be assessable against the key person for income tax or National Insurance if he or she is an employee of the partnership or limited liability partnership as the benefits belong to the business.

Key Person Income Cover for Sickness is likely to be tax deductible for the partnership or LLP if it meets the 4 tests opposite. The benefits are likely to be taxed as a trading receipt in the hands of the partners or members. If the benefits are going to be used for sick pay, they are still likely to be taxed in the hands of the partners or members, but when paid out to the employee they would become deductible, cancelling out the tax. The employee will of course be taxed on their pay as normal and they would therefore continue to pay income tax and employee's National Insurance. Therefore, if it is intended to use Key Person Income Cover for Sickness for sick pay, it may be preferable for the key person to take the plan out on his or her own life. The firm could pay the premiums, which would be taxed as a benefit in kind, but the benefit would be tax-free to the employee.

It is important to note that not claiming tax relief if the premium would have qualified will not prevent the sum assured being treated as a trading receipt and being taxed. Therefore, written confirmation should be obtained from the local HM Revenue and Customs Inspector that the premiums do not qualify for income tax relief, and that the benefits will not be taxable. However, this may not always be forthcoming. Draft letters to HM Revenue and Customs are on page 28.

Sole traders

If the plan is written on the sole trader's own life, premiums will be seen as personal expenditure and will not be deductible as a business expense. This usually results in the sum assured not being taxable. It may, however, be possible for the sole trader to argue that the premiums should be a deductible expense if the plan is on the life of an employee and meets the 4 tests below. If such a claim is successful then the payment of the sum assured may be taxable.

There are 4 tests to see if a premium is a tax-deductible expense for the sole trader.

These are:

- 1 The purpose of the plan is to solely protect against loss of profit.
- 2 The sole relationship should be employer/employee.
- 3 The plan must be a short-term assurance, which is normally understood to mean a non-convertible term insurance plan with a term of no more than 5 years.
- 4 The sum assured must be reasonable.

If the plan fails any of these tests, the premium will not be tax-deductible. For example, if the key person cover is taken out for a capital purpose it is unlikely that tax relief on the premiums would be granted, even if all 3 other conditions were met.

If the premiums qualify for relief from income tax, then the sum assured, when paid, would usually be treated as a trading receipt and subject to income tax. Therefore, to provide a given level of cover the sum assured must be increased to cover the 'tax loss'.

Key Person Income Cover for Sickness is likely to be tax deductible for the sole trader if it meets the 4 tests on the left. The benefits are likely to be taxed as a trading receipt in the hands of the sole trader. If the benefits are used for sick pay, they would become deductible when paid out to the employee, cancelling out the tax. The employee would of course be taxed on their pay as normal and would therefore continue to pay income tax and National Insurance. The sole trader would also still have to pay employer's National Insurance. Therefore, if it is intended to use Key Person Income Cover for Sickness for sick pay, it may be better for the key person to take the plan out on his or her own life. The sole trader could pay the premiums, which would be taxed as a benefit in kind, but the benefit would be tax-free to the employee.

It is important to note that not claiming tax relief if the premium would have qualified will not prevent the sum assured being treated as a trading receipt and being taxed. Therefore, written confirmation should be obtained from the local HM Revenue and Customs Inspector that the premiums do not qualify for income tax relief, and that the benefits will not be taxable. However, this may not always be easy to get. Draft letters to HM Inspector of Taxes are on page 28.

For example:

The sole trader takes out a 5-year term assurance with a sum assured of £75,000, with premiums of £300 a year. The income tax rate is 40% therefore the net cost of premiums after income tax relief would be £180.

In the event of a claim the income tax payable, assuming an income tax liability in that year of 40%, would be $£75,000 \times 0.40 = £30,000$. So the original sum assured needs to be increased to £125,000 to cater for the income tax liability.

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Ownership protection

The taxation treatment will depend on the solution and the type of plan chosen.

Life of another

- **Corporation tax**

Plans to cover company ownership will not meet the criteria for relief from corporation tax on the premiums. Therefore, payment of the sum assured for a term assurance plan will not be classed as a trading receipt, and so is unlikely to suffer corporation tax.

- **Capital gains tax**

As long as certain conditions are met, the purchase of the shares by the company can be treated as a capital gain rather than a distribution for taxation purposes. The advantage of this is that if the shareholder has died, the base value of their shares is revalued to the value at the date of death. Providing the shares have not increased in value between the shareholder's death and their sale to the company, the capital gains tax charge will be zero.

The conditions that need to be met are:

- The company must be an unquoted trading company or the holding company of a trading group.
- The purchase should take place for the benefit of the company's trade.
- The purchase is not part of a scheme to avoid tax.
- The seller should be resident and ordinarily resident in the United Kingdom in the tax year of the purchase.
- The shares must have been owned for at least 5 years before the date of the sale (3 years if they were inherited).
- The seller must not retain an interest of 30% or more in the issued share capital of the company.
- The vendor's interest should be substantially reduced. The holding after the repurchase should not be more than 75% of the holding before the purchase.

The percentage shareholdings detailed above include shareholdings in the name of the vendor's spouse or minor children.

It is important to remember in the event of a transfer of shares due to critical illness, that the critically ill shareholder may be liable to capital gains tax on any increase in the value of the shares over their acquisition costs.

It is therefore vital that the company consults with their accountant before agreeing the purchase.

- **Inheritance tax**

If the shares were sold because of the death of the shareholder, business property relief allows the transfer of 'relevant business property' at reduced rates of inheritance tax. In this context relevant business property is unquoted shareholdings that have been held for 2 years. Unquoted shares are any shares not listed on the main stockmarket; alternative investment market quoted shares count as unquoted. Currently, the business property relief for unquoted shares is 100%.

Own life in trust

• Income tax

If the individual shareholder, member or partner pays the premiums, this will come from their taxed income.

In the event of a partnership or LLP paying the premiums on behalf of a partner or member they will be taxed as partnership or membership drawings, unless the premiums are deducted from the partner's or member's capital, current or loan accounts.

If a company pays the premium on behalf of a shareholder the premium will be assessed for income tax and National Insurance on that benefit unless the premiums are deducted from a director's loan account.

There is no liability to income tax on the payment of the sum assured under a Bright Grey Business Protection Menu plan.

• Corporation tax

If the company pays the premium it can deduct the expense for corporation tax purposes as meeting a liability of a shareholder.

• Capital gains tax (CGT)

There is no personal liability, provided that the plan is written in trust from the start. If an existing plan is assigned into trust under a commercial arrangement it could be argued that the trustees acquired the plan for consideration. Any subsequent disposal by them, including a claim on the plan, could therefore give rise to a liability to capital gains tax as the original beneficial owner is not disposing of the plan and it was acquired for 'money or money's worth'.

The liability would be calculated by reference to the disposal proceeds, that is the amount they receive following a claim, less the premiums paid. Therefore a substantial capital gains tax liability could arise depending on individual circumstances. For this reason, the business trust can only be used at commencement.

It is important to remember in the event of a transfer of a share of a business due to critical illness, that the critically ill shareholder or partner may be liable to capital gains tax on any increase in the value of the share over their acquisition costs.

• Inheritance tax

The plan should be written in trust from inception. A plan written under trust as part of a bona fide business arrangement on commercial terms is not a gift and is therefore not normally subject to inheritance tax. The evidence of the business arrangement is the cross option agreement in single and/or double option format and the similar plans effected by the other shareholders or partners. It may also be desirable to equalise premiums. It is essential that no one outside the business arrangement should be included as a beneficiary under the trust to maintain commerciality.

But a liability may arise if the proceeds of the plan are still held in trust past the next 10-year anniversary of the date the trust was created. This could happen if, for example, a payment is made on critical illness but the ill owner does not immediately exercise their option to sell their share of the business. The plan proceeds could remain in the trust for future use by the other owners should the ill owner not return within 12 months. And the other owners then have an option to buy their share of the business.

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If a single or cross option agreement is used, business property relief that allows the transfer of 'relevant business property' at reduced rates of inheritance tax will be available. In this context relevant business property is unquoted shareholdings which have been held for 2 years or a partner's share in the business. Unquoted shares are any shares not listed on the main stockmarket; alternative investment market quoted shares count as unquoted. Currently, business property relief for unquoted shares or a partner's share in the firm is 100%.

If a buy and sell agreement is used then business property relief would be lost. This is because HM Revenue and Customs regard a buy and sell agreement as a binding contract for sale under which business property relief is not available because the value of the business is regarded as cash in the estate of the deceased owner.

If the business is a family business, inheritance tax and business property relief are unlikely to be affected as long as the arrangement is solely to protect the business and is arranged to protect only those with direct shareholdings.

SAMPLE LETTER



Date:
Ref No:

Dear Sir

ABC COMPANY LIMITED

The above company wishes to effect a plan on (name of life assured) for its own benefit. The plan chosen is a Bright Grey Business Protection Menu which will not acquire a surrender value and is non-convertible.

The details of the proposed plan are as follows:

Type of contract: (renewable) term assurance

Benefit type _____

Amount of cover £ _____

Premium amount £ _____

Term _____

Premiums will be paid monthly/annually* (delete as appropriate)

Position held by life assured: _____

Shareholding of life assured: _____

Shareholding of related persons*: _____

Main purpose of plan: _____

Please insert Paragraph A, Paragraph B, Paragraph C or Paragraph D as listed over the page.

Please could you confirm in writing whether or not the premiums paid under the above plan will be treated as a business expense for corporation tax purposes and whether the plan proceeds will be treated as a trading receipt or a non-taxable item on the capital account.

Yours faithfully

A stylized, handwritten signature in black ink, appearing to be a cursive 'A' followed by some illegible characters.

Company Accountant/Secretary

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Sample letters to HM Revenue and Customs

It is important that the tax treatment of company-owned key person and share protection plans is confirmed with HM Inspector of Taxes.

These are suggested wordings for letters to the local Inspector of Taxes.

TERM ASSURANCE PLANS

Suggested wordings for the main purpose of the plan:

- Paragraph A**
His/Her services are considered essential to the operation of the Company and the plan is being effected to protect the Company against the loss of profits that will arise as a result of (him/her) suffering a (critical illness) or on (his/her) untimely death.
- Paragraph B**
He/She has personally guaranteed (a) loan(s) to the Company which may become repayable (as a result of (him/her) suffering a critical illness) or on (his/her) untimely death.
- Paragraph C**
His/Her services are considered essential to the operation of the Company and the plan is being effected to cover the costs of finding a suitable replacement (as a result of (him/her) suffering a critical illness) or on (his/her) untimely death.
- Paragraph D**
On death (or as a result of suffering a critical illness) it is considered essential to the effective management of the Company that (his/her) shareholding is purchased by the Company. The plan is being effected to cover the costs of the share purchase.

Other wordings can be used if the purpose of the plan is different to those described above.

* Related persons could include any person whom the life assured may be able to influence.

Please note:

We cannot accept liability for the wording of the draft letter and financial advisers should satisfy themselves that it complies with the regulations of the Financial Services Authority.