Protection / Business Menu

Own Life in Trust and Company Share Purchase - A Comparison

Shareholder protection can appear complicated but we can help to make it simple

There are three main ways of establishing an arrangement:

1. Plans taken out on a life of another basis by each of the shareholders.
2. Own life plans written in trust.
3. Company share purchase.

Plans taken out by the shareholders on their co-owners on a life of another basis is the simplest method. However, there is potential for an unworkable number of plans. For this reason, the life of another method has limited scope. It should not be used where there are more than three shareholders, or if ownership of the business is likely to change in the future.

Often own life in trust and company share purchase will be considered the preferred routes to arranging shareholder protection. Each method is summarised in the following table which provides an overview of the main advantages and disadvantages.

	Own life in trust	Company share purchase
How is it set up?	• Each shareholder takes out an own life plan, to be written under a business trust from commencement. The shareholders will be potential beneficiaries and trustees of the trust. • The shareholders will enter into a cross option agreement, setting out the terms of the share purchase, such as options to buy and sell the shares and how the shares will be valued. • Premiums may need to be equalised to ensure that the amount being paid by each shareholder is commercial in relation to the benefit they could receive. A difference in premiums could have adverse Inheritance Tax consequences if equalisation does not take place, particularly where the settlor is included as a discretionary beneficiary of the trust.	• The company takes out a plan on the life of each shareholder. • The company and the shareholders will enter into a cross option agreement, setting out the terms of the share purchase, such as options to buy and sell the shares and how the shares will be valued. At the time the arrangement is established, there will be no guarantee that the company will be in a position to purchase the shares in the future. The agreement will usually be drafted so as to accommodate this uncertainty.
Who pays the premiums?	• The premiums may be paid by the shareholders from their post-tax income. • If the company pays and does not reclaim the cost from the shareholders, the premiums will be taxed as a benefit in kind. In this case, the cost to the shareholders (Income Tax and National Insurance) would be equalised, rather than the premiums. As the company will be meeting a pecuniary liability of a shareholder, the premiums will normally be deductible for Corporation Tax. Alternatively, if the shareholders have positive directors' loan accounts, premiums paid by the company could be treated as partial repayments of the loan accounts, without creating a benefit in kind. • Irrespective of who pays the premiums, benefits are paid to the trustees of the business trust. There may be an Inheritance Tax charge in relation to the trust in certain circumstances.	• The company will pay the premiums. As the company is the plan owner and will be entitled to any claim proceeds (usually free of Corporation Tax as a capital receipt), this will not create a benefit in kind for the shareholders. • Premiums will not usually be a deductible expense for Corporation Tax purposes.
Advantages	• Flexibility – with our specimen business trust, if the settlor leaves or retires from the business, the trust states that the plan will automatically be held on a bare trust for them. The settlor can then request for the trustee to transfer ownership to them, removing the trust. This means that the settlor can maintain the plan as personal cover if circumstances change. • Certainty – the company law requirements that could prevent a company share purchase from taking place do not apply. • New shareholders can be added as trustees and are automatically included as discretionary beneficiaries. • Leavers are also automatically removed as discretionary beneficiaries.	• Simple to set up as trusts and equalisation of premiums are not required. • Tax efficient – premiums will not be subject to Income Tax or National Insurance for the shareholders. • New shareholders can be added to the arrangement. The company would take out a plan on them and enter into a cross option agreement.
Disadvantages	• Equalisation of differences in premiums is needed to ensure commerciality. • A Pre-Owned Asset Tax (POAT) charge to Income Tax is possible. As the settlor of the business trust is included as a discretionary beneficiary, a charge to tax may arise if a critical illness or terminal illness claim is paid and the funds continue to be held in trust. For example, if the settlor decides not to sell his shares. A POAT charge can be avoided by removing the settlor as a discretionary beneficiary. We provide a specimen deed of removal. • Less tax efficient than company share purchase.	• Generally not suitable for new companies. To secure Capital Gains Tax treatment on the proceeds of the sale of shares, the seller should have held the shares for at least five years, or three years if the personal representatives are selling. Capital Gains Tax will usually be preferable to Income Tax and in many cases there will not be a charge to tax, but this will only apply if certain requirements are met, including the minimum length of ownership requirement. There is also potential for a Capital Gains Tax liability should the surviving shareholders eventually dispose of their shareholdings, the value of which having been increased by the company share purchase. • Less flexible if a shareholder leaves. The remaining directors may be unwilling to assign the plan to the leaver. If the plan is assigned, Income Tax and National Insurance are likely to be due on the premiums paid up to the date of transfer. • Uncertainty – at the time the arrangement is put in place, it will be uncertain whether the purchase will proceed. The share purchase may be prevented if, at the time of the proposed purchase, the requirements of the Companies Act 2006 in relation to company share buyback are not met. The main requirements of the Act can be summarised as follows: • The company's articles of association must permit share buyback or an ordinary resolution (requiring more than 50% votes in favour, but excluding the shareholder who is selling the shares). The purchase must be approved by an ordinary resolution. • The company must use distributable profits to fund the purchase, before capital can be used. The accounting treatment in relation to the plan proceeds will be determined by the company's professional advisers. The sum assured may be recorded as an exceptional or extraordinary receipt in the profit and loss account or perhaps as a capital receipt – the accountant should be able to confirm the correct approach in a particular case. If the purchase is to be funded from capital, which may include the plan proceeds, there are additional requirements to be met: • The directors must make a statement that the purchase will not prejudice creditors, accompanied by an auditor's report, to be delivered to the Registrar of Companies. • Notices to creditors must be placed in the Gazette and a national newspaper. If the company has substantial debts, creditors may prevent the share purchase by applying to the court.

The tax advantages of company share purchase

In the example below, company share purchase represents a 38% saving compared with the own life in trust method where the individual pays their own premiums from take-home pay.

	Own life in trust Premiums being paid by the shareholder from post-tax income £1,000	**Company share purchase** Premiums being paid by the company £1,000
Company gross cost		
Employee income tax @ 40%	£689.66	nil
Employee's National Insurance @ 2%	£34.49	nil
Employer's National Insurance @ 15%	£258.62	nil
Gross cost	**£1,982.77**	**£1,000**
Company net cost		
Corporation tax relief @ 19%	£376.73	nil
Net cost	**£1,606.04**	**£1,000**

Important Note: The example assumes: The shareholder is resident in England, Wales or Northern Ireland, Income Tax 40%, employer's National Insurance 15%, employee's National Insurance 2%, Corporation Tax at 19% and the local inspector of taxes has agreed that premiums are deductible as a trading expense for the company. Different rates of income tax apply in Scotland.

Replacing existing cover could result in more expensive premiums or the client may no longer be insurable.

This information is based on our present understanding of current tax and HM Revenue & Customs practice. It may be affected by future changes and individual circumstances.

18 61

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