

YOUR GUIDE TO PARTNERSHIP PROTECTION.




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INTRODUCTION.



The purpose of this guide is to explain how our Partnership share protection scheme operates. Please note that this does not cover Limited Liability Partnerships (LLPs). Please see our Limited Liability Partnership Trust and Technical Guide if your partnership is a LLP.

This guide aims to answer the most common question that that you may be faced with dealing with this topic.

This guide describes our method of setting up partnership share protection utilising life or life and critical illness policies placed in trust, plus a written agreement between the partners in the partnership.

The documents we use in this guide are for specimen purposes only and professional advice should be sought. All examples used in this guide are based on using our trust forms. There may be other documents that may be more suitable.

Descriptions of the agreements and the trust forms in this guide are based on specimens we've produced. However, clients should seek their own advice as to how their agreements and trust forms are drawn up and what documentation is required.

We accept no responsibility for ensuring that the trust from and cross option agreement meets the partners requirements.

▶ YOUR GUIDE TO PARTNERSHIP PROTECTION.

WHAT IS THE AIM OF THE AGREEMENT?

A share protection arrangement is required to enable partners to purchase the share of the business from the deceased partner. This provides the deceased partner's dependants with a willing buyer and cash instead of an interest in a business.

Our partner's share protection plan is designed to ensure that funds are available in the right hands to purchase a partner's shares on their death. An option is also given to the deceased's personal representatives to sell the deceased's share to the continuing partners on death.

Critical Illness Cover can also be added at an extra cost, the agreement gives a partner the option to sell their share if they are diagnosed with one of the critical illnesses we cover.

In order for the agreement to be implemented each partner must effect and maintain a life or life and critical illness policy, which is written in trust for the other partners. An agreement, typically a cross option agreement provides the basis for the share purchase and details how the purchase can be made.

The agreement should be kept with the partnership agreement. One agreement covers all the partners. The completed trust document will be returned to the trustees and be kept with the policy(ies).

WHY IS AN AGREEMENT NEEDED?

Without a partnership agreement, the death of a partner automatically dissolves the partnership and the estate of the deceased partner becomes entitled to the value of the deceased partner's interest in the business.

For the remaining partner(s) this means either selling the business to pay off the estate, selling assets to pay off the estate and then setting up business as a sole trader or starting a new partnership with someone else, or coming to an arrangement with the estate to, for example, set up a new partnership with the widow/er.

For the widow/er this might mean either an inadequate price is paid to compensate for the late spouse's business interest or them being forced into business.

Even if there's an agreement to allow the business to carry on after the death of a partner, there may be insufficient money to adequately compensate either the deceased's estate or the remaining partners.

Most surviving partners in this situation will want to buy the deceased partner's share in the business and keep control. Only a few will have the right amount of cash at the right time. Some businesses turn to their bankers, but many have existing loans that rule out further advances. Also a crisis, such as the death of a partner, tends to create uncertainty and instability within a partnership, so banks will be less likely to be willing to make a loan. Serious illness could have a similar impact.

HOW DOES THE AGREEMENT OPERATE?

The agreement is able to include options on death, terminal illness and, if selected, critical illness. The partners should indicate in the agreement which events they wish to plan for, which should be reflected in the type of policies being arranged. The agreement operates as follows:

Death

On the death of a partner their personal representatives have the option to sell their share in the business to the surviving partners and the surviving partners have the option to buy the deceased partner's share from the personal representatives. If an option is exercised by either party then the other party would be bound to buy or sell, as the case may be.

The partners can exercise their option to buy the share at any time within three months of the date of death.

The personal representatives can exercise their option to sell the share at any time within six months of the date of death. And if required:

Terminal Illness Cover

A partner suffering from a diagnosed terminal illness that results in a valid claim, will have the option to sell their shares to the other partners.

This option is available for six months after the date of receipt of the sum assured;

n.b. there is NOT an option for the other partners to buy the shares from the terminally ill partner. A single option agreement leaves the terminally ill partner in control, with the option to sell but with no corresponding option to buy given to his/her co-partners. On payment of a valid terminal illness claim no further benefits will be payable and the policy will end.

Critical Illness

A partner suffering from one of the specified critical illnesses or disabilities that results in a valid claim under a life and critical illness policy, will have the option to sell their share in the business to the other partners. This option is available for six months after the date of receipt of the sum assured under the life and critical illness policy, and not from the date that the critical illness is diagnosed;

n.b. there is NOT an option for the other partners to buy the share from the critically ill partner. Although this option could be attractive to the other partners, it may not be for the partner who has had a heart attack and who intends to resume work, once fully recovered, after only a few months. A single option agreement leaves the critically ill partner in control, with the option to sell but with no corresponding option to buy given to their fellow partners. On payment of a valid critical illness claim no further benefits will be payable and the policy will end.

Under the agreement, each partner must effect and maintain a life or life and critical illness policy under the appropriate trust, to provide the required amount to purchase the share in the business. The beneficiaries of the trust would be the fellow partners. This ensures that the proceeds from a policy are available for them to buy the partner's share on death or on diagnosis of a critical illness.



For further information on terminal illness, please refer to the Key Features Document.

For further information on the critical illnesses we cover please ask for a copy of our Guide to Critical Illness Cover.

WHY IS THE AGREEMENT NOT BINDING?

Under current legislation the partner's share may qualify for 100% Business Property Relief for Inheritance Tax purposes. However, if the share purchase agreement in force was a binding contract for sale, such as a buy and sell agreement, Business Property Relief would be lost. This may not be important if the share is to pass on death to the spouse (which is fully exempt from Inheritance Tax). Nevertheless, this exemption should not be relied upon as the spouse may die before the partner. Consequently, if a binding agreement for sale were in place further Inheritance Tax planning might be required.

A cross option agreement however is not a binding contract for sale and therefore preserves Business Property Relief. This gives the surviving partners an option to buy the partner's share and the personal representatives of the deceased have a matching option to sell to the surviving partners.

WHAT PRICE IS TO BE PAID FOR THE SHARE?

It is important that when putting a cross option agreement in place that an appropriate method is agreed on how the partnership is to be valued.

Open market value of the business

This option would ensure that all parties are fairly treated. This can, however, lead to certain practical problems, such as how the business can be sure that the amount of cover in force equates to the value that would have to be paid? The reference to open-market value means that this has to be formally arrived at. This could lead to delays in the completion of the sale and purchase and often can result in the whole plan being delayed or even never finalised.

Fixed value for the partnership

By adopting a fixed price method of valuation, the business adopts a method of valuing the partnership. This method ensures that the appropriate level of life cover can be effected.

Legal & General's cross option agreement has been drafted on the basis that should death or terminal illness (or payment under a life and critical illness policy) occur within three years of the agreement being established a specified value (as written into the agreement) will be the price to pay for the deceased partner's share of the partnership. However, if death or terminal illness (or payment under a life and critical illness policy) occurs more than three years after the date of the agreement a 'fair value' will be paid.

Fair value of the share of the partnership

This will be the relevant proportion of the market value of the partnership as at the date of the partner's death or the Payment Date (as the case may be). This amount will be determined by an independent auditor or professional valuer who will be appointed by the surviving partners and the personal representatives of the deceased partner. If such a valuation is not carried out then the 'fair value' of the partnership shall be the relevant proportion of the said market value as determined by the President for the time being of the Institute of Chartered Accountants in England and Wales.

Such an arrangement should be reviewed at least every three years to ensure it continues to meet the business's requirements. The sum assured under the life or life and critical illness policy should be reviewed at the same time. If this is not done the price to be paid under the agreement reverts to the 'fair value'.

Whilst Legal & General provide a cross option agreement, it is important that the partners get their agreement approved by their own legal advisers.

WHAT IF NEW PARTNERS JOIN THE BUSINESS?

All new partners should enter into the arrangement by completing a supplemental agreement. An additional life or life and critical illness policy must also be effected and the appropriate trust forms completed.

HOW LONG DOES THE AGREEMENT LAST FOR?

The agreement can last indefinitely but, as mentioned earlier, regular reviews should be carried out.

WHAT ARE THE TAXATION EFFECTS OF THE ARRANGEMENT?

INHERITANCE TAX

Providing all partners participate, there will be no Inheritance Tax on the premiums payable, as it will be considered to be a bona fide commercial arrangement. If this were not the case, life policy premiums would usually fall within one or more of the Inheritance Tax exemptions. The proceeds of the life or life and critical illness policy when written under trust will be payable to the trustees normally free from Inheritance Tax, since they don't form part of the deceased's estate. The estate of the deceased partner includes the share of the business and not cash, thus preserving Business Property Relief on the value of the share.

Periodic charge

An Inheritance Tax liability may arise on each ten year anniversary of the creation of the trust. The charge is based on the value of the property in the trust, which is referred to as 'relevant property'. The value of the relevant property will be the value of the policy. The maximum rate of tax that can be charged on the relevant property is currently 6% of the assets over the nil rate band, less any chargeable transfers made by the shareholding director in the seven years preceding the creation of the trust. A periodic charge may become payable where the partner dies and the value of the policy proceeds exceeds their available nil rate band.

Exit charge

An Inheritance Tax liability may arise where capital leaves the trust. For example, a charge may arise where the trustees pay the policy proceeds to a beneficiary following a claim. Different calculations are done depending on whether the distribution of capital occurs before or after the first ten year anniversary of the trust.

Where an exit occurs during the first ten years, the calculation is based on the values at the creation of the trust. Where the exit occurs between ten year anniversaries, the calculation is based on the values at the previous ten year anniversary. In either case, the rate of tax upon which the exit charge is based is a maximum of 6%.

CAPITAL GAINS TAX

There is no Capital Gains Tax on death but there could be a liability on beneficiaries of the estate on the increase in value of the share of the business between death and sale although in practice this would be rare.

A Capital Gains Tax liability may arise however, in the event of the sale of a partner's share due to a terminal or critical illness.

INCOME TAX

An Income Tax liability may arise from the potential reversion of the trust fund to the partner if the partner should resign or retire from the partnership or otherwise cease to be partner or the partnership should be dissolved other than as a result of the death of the partner. This is also known as Pre-Owned Asset Tax (POAT).

HOW ARE FUNDS TO MAKE THE PURCHASE PROVIDED?

A life assurance or life and critical illness plan is written on the partner's own life. The cross option agreement states that each partner shall, no later than one month after the date of the agreement, effect either a life policy or a life and critical illness policy. Each policy will be subject to a trust for the other partners so that, if there is a death or critical illness claim, the proceeds of the plan would be paid to the continuing partners to enable them to purchase the deceased's/critically ill partner's share of the business. Examples of these forms are available from us, and details on how to complete the trust is included in this guide.

WHO SHOULD PAY THE PREMIUMS?

Each partner undertakes to pay premiums on their own life. These may not necessarily be the same because of the different ages and sums assured. If possible, the partners should adjust their drawings to compensate for this.

WHAT TYPE OF POLICY SHOULD BE EFFECTED?

This will depend upon individual circumstances and affordability. For example, if it is not known when a partner will retire, a Whole of Life Protection Plan may be an appropriate policy.

If Critical Illness Cover is required this can usually be arranged as an additional option to a term assurance policy.

WHAT IF A PARTNER LEAVES THE BUSINESS?

If a partner leaves the business the agreement will normally cease to apply to that partner.

The policy would automatically revert to the partner.

WHAT IF THE SUM ASSURED DOESN'T MATCH THE PRICE TO BE PAID FOR THE SHARE AS SPECIFIED IN THE AGREEMENT?

If the agreement is reviewed regularly and updated regularly, it's unlikely that the proceeds of the life policies will differ significantly from the price to be paid for the share. However, if the specified sum isn't reviewed and the agreement not amended, then the price to be paid under the agreement reverts to the **open market value**. This is the traditional method of share valuation, and it could mean that the sums assured under the policies may not match the price to be paid. The agreement should therefore be frequently reviewed.

If the sum assured is less than the agreed value, the agreement gives the option for the balance to be paid to the deceased's partner's personal representatives in instalments over an agreed period. The agreement allows specific details to be inserted regarding the number and frequency of payments. This amount may or may not bear interest and the wording should be deleted as appropriate where necessary.

If however, the sum assured exceeds the agreed value, the surviving partners can, if they wish, pass the excess to the deceased partner's personal representatives or keep it themselves. The agreement caters for either arrangement and if this form is used then the appropriate wording should be inserted.

WHAT IF THE PARTNERS DON'T WISH TO SPECIFY A VALUE FOR THE PARTNERSHIP SHARE TO BE PURCHASED?

Partners ought to be encouraged to specify a value. If they don't, then an amendment to the agreement will be needed in order to revert to the ordinary open market value at the time the purchase is made.

WHAT IF THERE IS ALREADY A SHARE PURCHASE AGREEMENT IN FORCE?

It is important that this is reviewed. We provide a specimen agreement for the consideration of the client's legal advisers, should they wish to change it. The partnership's legal advisers should ensure there is no conflict between any existing partnership agreement and the wording of the cross option agreement.

▶ OTHER SHARE PROTECTION ARRANGEMENTS.

There are also other methods of share protection (for example buy and sell and automatic accrual) and other ways of writing the life policy (for example life of another, absolute trust and joint life first death).

THE BUY AND SELL AGREEMENT

The partners enter into an agreement whereby on retirement or death, the retiring partner or his estate will sell their share to the remaining partners who, in turn, will buy. The partners will purchase the share in the proportion in which the remaining share in the business is held. There may be disadvantages in using the buy and sell method such as the loss of Business Property Relief so, when a partner dies, their share of the business may be liable to Inheritance Tax.

THE AUTOMATIC ACCRUAL METHOD

In the event of death, the partner's share is automatically acquired by the surviving partners in accordance with an agreement between them. A life policy may be used as part of such an agreement in order to compensate the deceased's family.

LIFE OF ANOTHER

As a way of writing the life policy, has its limitations in that it's inflexible when the business dissolves or when new partners join.

If there are only two participants a joint life policy can be written.



Note: Similar share protection schemes can be arranged for directors of Private Limited Companies and members of Limited Liability Partnerships. See our technical guides entitled 'Your Guide to Director's Share Protection' and 'Your Guide to Limited Liability Partnership Share Protection'. We also offer key person protection. See our technical guide entitled 'Your Guide to Key Person Protection'.

TRUST INFORMATION.

WHY USE A TRUST?

A trust is a way of transferring the policy (the asset) to the other partners (the beneficiaries) but without giving them full access to and control over it. The trust will also specify who the partner wants to look after and control the asset (the trustees).

WHO IS A BENEFICIARY?

The beneficiaries are the other partners in the partnership.

WHAT IS A TRUSTEE?

A trustee is someone the partner appoints to look after the asset(s) they are putting in trust (for example, their Legal & General business protection policy). The trustees are the legal owners of the trust assets. They must keep to the conditions of the trust, and act for the benefit of the beneficiaries of the trust. When the trust asset is a life assurance policy, in the event of the partner's death, the trustees will need to make a claim for the proceeds and ensure that these proceeds are passed to (or used for) the beneficiaries of the trust.

WHO CAN BE APPOINTED AS A TRUSTEE?

Normally the other partners would be appointed as trustees. It is also a good idea for them to be resident in the United Kingdom. Solicitors and accountants can act as trustees but they will charge for their services.

CAN THE PARTNER BE A TRUSTEE?

Yes. The partnership trust automatically makes the partner a trustee.

CAN THE PARTNER APPOINT ADDITIONAL TRUSTEES IN THE FUTURE?

Yes, with our partnership protection trust the partner has the power to appoint additional trustees at any time. After the partner dies, the trustees will have the power to appoint additional trustees.

HOW MANY TRUSTEES SHOULD THE PARTNER CHOOSE?

It is a good idea to have at least two trustees at any time. For this reason, it is normally sensible to appoint at least two trustees in addition to yourself.

WHAT HAPPENS IF A TRUSTEE DIES?

If a trustee dies, the remaining trustees can still carry on but a replacement could be appointed. If the trustee was the last surviving trustee, their legal personal representatives will have the power to appoint additional trustees or take over as trustees themselves.

WHAT HAPPENS IF A TRUSTEE NO LONGER WANTS TO BE A TRUSTEE?

A trustee can retire from the trust with the consent of the other trustees, provided that there are at least two trustees following the retirement.

HOW DO THE TRUSTEES MAKE A CLAIM?

In the event of your death the trustees will need to send the following items to Legal & General's Life Claims Department:

- Partnership trust (and any subsequent deeds)
- The original policy document
- An official death certificate.

THE ADDRESS TO SEND THESE ITEMS TO IS:

Legal & General Life Claims Department
City Park
The Droveaway
Hove, East Sussex BN3 7PY

Once the claim is accepted, the trustees will be paid by direct credit.

QUICK CHECKLIST FOR THE PARTNERSHIP PROTECTION TRUST

Before sending the trust to Legal & General, have you

1. Dated the trust?
2. Completed the Settlor's details?
3. Completed the Additional Trustees details?
4. Inserted the name of the Partnership?
5. Completed the details of the application?
6. Crossed through mistakes (rather than using correction fluid) and have all parties initialled any changes?
7. Signed the trust and had those signatures witnessed?

IMPORTANT NOTES.

We have written this guide to give general information about placing business protection policies in trust for partners. It is not intended to replace legal advice. If this trust does not meet the partner's needs then they should talk to their legal and financial advisers.

We have based the information in this guide on our understanding of the laws relating to trusts and inheritance tax at the time of publication. Although we have made every effort to make sure that the information is accurate, we cannot take legal responsibility for any particular statements.

This guide is based on our understanding of current law and HMRC practice, which can change.

In preparing this guide we have assumed that only Legal & General's Partnership Protection Trust is to be used in conjunction with Legal & General's business protection policies. We can also provide key person, director's share and limited liability partnership share trust forms. The information in this guide does not apply to family protection. Legal & General have separate literature for family protection. Please see your financial adviser for more details.



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