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Partner's Share Protection Technical Guide

Note:

This guide has been prepared according to our interpretation of current tax law and HMRC practice. Tax law and tax rates may change in the future.

Introduction

The purpose of this guide is to explain how our partner's share protection scheme operates.

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

This guide refers to 'Partners'. By this we mean full equity partners of which there must always be at least two in any partnership. It's important to realise that (except in Scotland) a partnership is not a separate legal entity, unless it is a limited liability partnership. A partnership is a relationship between individuals (the partners) who carry on business together.

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

The documents we've used 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 trust forms in this guide are based on specimens we've produced. However, clients should get 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 form and cross option agreement meets the partner's requirements.

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, to give the partner affected the option to sell their share if they are diagnosed with one of the critical illnesses we cover.

An effective partner's share protection plan should provide:

1. Flexibility.
2. Capital that is available in the right hands at the right time.
3. Tax efficiency.

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

The cross option agreement should be inserted into the partnership agreement. One agreement covers all the partners. The completed trust document will be returned to the trustees and should 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 late partner's widow/er.

For the widow/er this might mean an inadequate price to compensate for the late spouse's business interest or being forced into business against their will.

Even if there's an agreement to allow the business to carry on after the death of a partner there may be no money to adequately compensate the estate or the partners for the loss of a partner.

None of these alternatives bode well for successful business, or fairness to a deceased's family.

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.

The solution is forward planning to ensure the right amount of cash is available at the right time through a life assurance or life and critical illness cover policy.

How does the agreement operate?

The agreement is able to include options on death 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:

Critical illness - Any partners suffering from one of the specified critical illnesses or disabilities that results in a payment 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. You should note that 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 very mild 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 if they so desire 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, so 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 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 many shares will qualify for 100% Business Property Relief for Inheritance Tax. But if the share purchase agreement in force was a binding contract for sale, such as a buy and sell agreement, this valuable 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 this method preserves Business Property Relief. This method simply 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 as to how the partnership is to be valued.

The open market value of the business could be used. This would ensure that all parties are fairly treated. This can, however, lead to certain practical problems, such as how can one be sure that the amount of cover in force equates to the value that would have to be paid? Indeed, the very reference to open-market value means that such a value has to be formally arrived at. This will inevitably cause some delay in the completion of the sale and purchase but perhaps more seriously, it is this issue that often means the whole plan is delayed or even never finalised.

The answer for many partnerships may be to elect for a fixed value for the partnership for the purpose of the cross option agreement. By adopting a fixed price method of valuation, one is merely adopting a method of valuing the partnership. This method ensures that the appropriate level of life cover can be effected.

Legal & General's specimen cross option agreement has been drafted on the basis that should death (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 partnership. However, if death (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. The fair value of the share of the partnership 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. Once the agreement is set up it should not just be left to rest but constantly reviewed and kept in line with reality. This should also give a good opportunity to review the life and critical illness (if selected) policy. If the specified sum is not reviewed, then the price to be paid under the agreement reverts to the 'fair value'.

Whilst Legal & General provide a specimen 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.

If the beneficiaries section on the trust form is left blank, then the trust will automatically pay out to all the surviving partners in proportion to their entitlement to share in income profits.

If the beneficiaries section was completed and a new partner joined, the trustees will need to add them to the trust. This is quite simple to do and we can provide the necessary forms.

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 cross option agreement?

Inheritance Tax

Provided that 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 for some reason 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.

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 critical illness.

How are funds to make the purchase provided?

A life assurance or life and critical illness plan is written on the partners 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 all be the same because of 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 what can reasonably be afforded. 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 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 on their life may be appointed to them if all the trustees agree, may be maintained, or lapsed by the trustees.

It's possible for outgoing partners, if they retain assets in the business, to stay in the scheme but this is rare.

What if the sum assured doesn't match the price to be paid for the share as specified in the agreement?

If there are regular reviews of the agreement it's unlikely that the proceeds of the life policies will not match the price to be paid for the share. However, of course, 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 partners 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 and, 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 will be important to encourage the clients to review this agreement. 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

You may come across 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, joint life first death).

The buy and sell agreement. With this method 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.

Under 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. Again, there is no flexibility when someone joins or leaves and if one partner dies the survivor no longer has any life cover.

Note: Similar share protection schemes can be arranged for directors of Private Limited Companies. See our technical guide entitled 'Director's Share Protection'.

Case study

Overleaf is a completed trust form based on the following case study:

John Spencer, Stephen Young and Mark Jones are partners in Spencers Plant Hire.

Each partner effects a term assurance policy for a sum assured which matches the current value of their share in the business. All three policies are written under trust. One cross option agreement is required.

Partners' share protection trust documentation

Specimen of correctly completed Declaration of Trust

Partnership Share Protection Documentation Pack

DECLARATION OF TRUST FOR PARTNERS

This Declaration of Trust is to be incorporated in the application form dated **14/05/09** ("the Application")

made by **JOHN SPENCER** ("the Settlor")

for (a) **TERM ASSURANCE** policy(ies) on the life of the Settlor.

In this Declaration of Trust the following expressions shall have the following meanings:-

SECTION A
 The Beneficiaries means the Settlor and his/her partners in the Firm
 The Firm means **SPENCER'S PLANT HIRE** and their successor in business

The Policy means the policy or policies effected pursuant to the Application which expression wherever used in this Declaration shall include the benefit of the insurance contract or contracts completed pursuant to the acceptance of the Application and any variation or amendment to the said contract or contracts hereby authorised referred to The Trust Fund means the Policy the full benefit thereof all property at any time held by the Trustees upon the trusts declared in this Declaration of Trust whether by way of further settlement accumulation of income capital accretion or otherwise and all property from time to time representing the foregoing respectively Legal & General means Legal & General Assurance Society Limited.

SECTION B
 The Default Beneficiary(ies) are

Name	Shares	Name	Shares

SECTION C
 The Additional Trustees are


First Trustee Name: STEPHEN YOUNG DOB: 19 OCTOBER 1966 Address: 12 THE PARADE BRIGHTON Postcode BN2 7AG	Second Trustee Name: MARK JONES DOB: 04 MAY 1968 Address: 55 GROVE PARK WORTHING Postcode BN18 2PW
Third Trustee Name: DOB: Address: Postcode:	Fourth Trustee Name: DOB: Address: Postcode:

The Trust Period means the period of 79 years from the date of this Declaration which period shall be the Perpetuity Period for the purposes hereof. I hereby request and declare that the Policy be issued to me as Trustee and expressed to be held upon an irrevocable trust (hereinafter called the Trust) subject to the trust powers and provisions set out below. I further desire to appoint the Additional Trustees to act with me as trustees of this Trust (and we jointly hereinafter shall be called "the Trustees" which expression shall include the trustees for the time being of the Trust) and the receipt by the Trustees of any moneys payable under the Policy shall discharge Legal & General's liability for all such moneys.

Please refer to completion notes at the back of this section.

TO BE COMPLETED BY IFA/AGENT

Name: <input type="text"/>	Agency Name: <input type="text"/>
Address: <input type="text"/>	Agency Number: <input type="text"/>
Tel/Fax: <input type="text"/>	Date: <input type="text"/>



Date of life assurance application form →

Full name of life assured →

Contract name →

Name of the partnership that is the business of the settlor →

This section should be left blank unless the beneficiaries are NOT the other partners for the time being in the firm in shares equivalent to their entitlement to share in income profits, in which case the names and shares should be entered →

Name and addresses of the additional trustees – usually the settlor's partners →

TRUST PROVISIONS

1. During the Trust Period the Trustees shall have power by deed or deeds revocable (whether by the person(s) making the deed or some other person(s)) during the Trust Period or irrevocable to appoint part or all of the Trust Fund and the income thereof for the benefit of such one or more of the Beneficiaries in such one or more shares and for such interests and subject to such trusts powers and provisions (including protective trusts discretionary trusts or powers operative or exercisable at the discretion of the Trustees or any other persons) as the Trustees shall in their absolute discretion think fit Provided Always that any appointment in favour of the Settlor can only be made by at least two Trustees of whom the Settlor is not one.
2. Subject to and in default of any appointment made under paragraph 1 above and subject to paragraph 5 hereof the Trustees shall hold the Trust Fund and the income thereof absolutely for the Default Beneficiary(ies) and if more than one in the percentage shares specified in Section B above and if no shares are specified in equal shares absolutely.
3. If no Default Beneficiary is indicated in Section B above then subject to and in default of any appointment made under paragraph 1 above and subject to paragraph 5 below the Trustees shall hold the Trust Fund and the income thereof absolutely for the person or persons (other than the Settlor) who is or are for the time being partner(s) in the Firm and if more than one in the like percentage in which they would be entitled for the time being to share among themselves in any income profits of the business of the said Firm ignoring the share of the said profits to which the Settlor and any partner(s) precluded from benefitting by paragraph 5 below were entitled.
4. The trusts hereby declared shall carry the intermediate income but section 31 of the Trustee Act 1925 shall not apply and where the Beneficiary entitled to income is a minor the Trustees shall hold such income for the absolute benefit of any such minor Beneficiary as shall be entitled thereto.
5. Notwithstanding the foregoing, no person shall be capable of benefitting under paragraphs 1-3 hereof unless he has settled a contract of life assurance, critical illness or terminal illness contract on his own life on trusts similar to those contained herein for the Beneficiaries not excluded from benefitting by this paragraph 5 and the benefit to which any such person would but for this paragraph 5 be entitled shall accrue to and form part of the entitlement of the person(s) not so excluded by this paragraph 5 from benefitting and if more than one in proportion to the entitlement inter se that they have in the absence of this paragraph 5.
6. The statutory powers of advancement contained in section 32 of the Trustee Act 1925 or if applicable Section 33 of the Trustee Act (Northern Ireland) 1958 shall apply to the trusts hereof with the following variation that is to say the omission in proviso (a) to sub-section (1) of the said section of the words "one-half of" Section 31 of the Trustee Act 1925 or if applicable Section 32 of the Trustee Act (Northern Ireland) 1958 shall not apply to the trusts of this policy.
7. Any Trustee for the time being (other than the Settlor) being a solicitor or other person engaged in any profession or business shall be entitled to charge and to be paid all usual professional or other charges for business done by him/her or by his/her firm in relation to the trusts thereof.
8. There shall be vested in me a power of removal of any trustee and a power of appointment of a new trustee and or additional trustee(s) during my lifetime and thereafter a power of appointment only shall be vested in the Trustees provided always that a power of removal shall be exercisable only if there are at least two individuals remaining as Trustees of which at least one is not the Settlor.
9. The Trustees may at their discretion and subject to the trusts aforesaid either retain the Policy or deal with the Policy in any manner that they may in their absolute discretion think fit including power (where the Policy so permits but without prejudice to the generality of the foregoing) to surrender the Policy or convert the Policy in accordance with the options available under the Policy. Any new policy or increase or decrease of benefits secured by the Policy or by any new policy or policies which is or are effected under any options which are contained in the Policy shall be subject to the same trusts as are herein declared.
10. Any moneys liable to be invested hereunder may be invested or laid out in the purchase or at interest upon the security of such stocks funds shares securities investments or property of whatsoever nature and wheresoever situate and whether involving liability or not and whether producing income or not (including the improvement repair insurance (in any value and against any risk) rebuilding and decorating of any property for the time being comprised in the property subject to the trusts hereof or the execution of any other works on or for the benefit of any such property) and including any policy or policies of life assurance whether in the name of a nominee or not as the Trustees shall in their absolute discretion think fit to the intent that the Trustees shall have the same full and unrestricted power of investing and transposing investments as if they were absolutely entitled thereto beneficially.

I hereby declare that I intend to pay the premiums under the Policy for the sole benefit of the persons beneficially interested from time to time under this Trust and I hereby irrevocably disclaim any lien or charge on the Policy for the repayment of any such premiums.

It is hereby certified that this instrument falls within Category N of the Schedule to the Stamp Duty (Exempt Instruments) Regulations 1987.

This trust shall be governed in by the law of England and Wales.

Name of Settlor:

JOHN SPENCER

Signature of Settlor:

John Spencer

Date:

14th May 2009

Full name of settlor

The settlor should sign and date.

Deed of assignment

DEED OF ASSIGNMENT/ASSIGNATION

for Head office use only

This Assignment/Assignment is made on the _____ day of _____ (year)

Between (name of Grantee) **JOHN SPENCER** D.O.B: _____
of (address) **112 CRAWLEY STREET, CRAWLEY**

hereinafter called 'the Grantee' of the one part and the Grantee
and (name of first Additional Trustee) **STEPHEN YOUNG** D.O.B: **2/12/1952**
of (address) **12 THE PARADE, BRIGHTON, BN2 7AG**

and (name of second Additional Trustee) **MARK JONES** D.O.B: **12/12/1955**
of (address) **55 GROVE PARK WORTHING**

and (name of third Additional Trustee) _____ D.O.B: _____
of (address) _____

and (name of fourth Additional Trustee) _____ D.O.B: _____
of (address) _____

hereinafter called 'the Trustees' of the other part

Whereas the Grantee is the Grantee of the Policy(ies) of Assurance (hereinafter called 'the Policy(ies)') specified in the Schedule hereto and holds the Policy(ies) upon the trusts and with and subject to the powers and provisions therein set out
and whereas the Grantee has appointed the Trustees as Trustees to receive the moneys payable under the Policy(ies) and is desirous of assigning the Policy(ies) to the Trustees
Now this deed witnesseth that the Grantee as Trustee hereby assigns the Policy(ies) unto the Trustees to hold the same unto the Trustees upon the Trusts and with and subject to the powers and provisions upon which and subject to which the Grantee holds the same and the Trustees hereby accept such trusts
It is hereby certified that this instrument falls within Category A of the Schedule to the Stamp Duty (Exempt Instruments) Regulations 1987.
In witness whereof the said parties to these presents have hereunto set their hands the day and year first above written
The Schedule herein before referred to _____

Office: **Legal & General Assurance Society Limited** Date _____ Policy No. _____ for Head office use only

Signed and Delivered as a Deed by the said
Full name of Grantee **JOHN SPENCER**
Signature of Grantee *John Spencer*
Witness's signature and address **D Smith, 27 THE PARADE, HORSHAM, SUSSEX**

Signed and Delivered as a Deed by the said
Full name of first Additional Trustee **STEPHEN YOUNG**
Signature of first Additional Trustee *S Young*
Witness's signature and address **D Smith, 27 THE PARADE, HORSHAM, SUSSEX**

Signed and Delivered as a Deed by the said
Full name of second Additional Trustee **MARK JONES**
Signature of second Additional Trustee *Mark Jones*
Witness's signature and address **D Smith, 27 THE PARADE, HORSHAM, SUSSEX**

Signed and Delivered as a Deed by the said
Full name of third Additional Trustee _____
Signature of third Additional Trustee _____
Witness's signature and address _____

Signed and Delivered as a Deed by the said
Full name of fourth Additional Trustee _____
Signature of fourth Additional Trustee _____
Witness's signature and address _____

Do not date

Full name and address of grantee (life assured)

Full name and address of additional trustees

Do not date

Signatures and witnesses of the above