PENSIONS
INVESTMENTS
LIFE INSURANCE

Irish Life

PARTNERSHIP INSURANCE

AN ADVISER GUIDE

Life Advisory Services

For Financial Adviser use only

This document provides an outline of the taxation issues to be considered when you are putting together a business protection arrangement for your clients and is based on our understanding of current legislation and Revenue practice.

In all cases we would recommend that business owners obtain professional legal and tax advice to ensure that any arrangement they put in place is appropriate to their personal and corporate circumstances.

CONTENTS

1. THE DEATH OF A PARTNER

1.1 THE CONSEQUENCES

The sudden death of a partner in a firm can cause problems for both the surviving partners and the deceased's next of kin.

1.2 FOR THE SURVIVING PARTNERS THE PROBLEMS THAT CAN ARISE ARE:

The partners may be legally bound, either under their own Partnership Agreement, or under the Partnership Act 1890, to pay an immediate capital sum to the deceased partner's estate in respect of:

- the deceased partners share of undrawn profits for the year in which he / she died.
- the deceased partners share of any partnership fixed assets, such as the office-building.
- the balance of his / her capital or loan account.
- a payment in respect of the deceased partners share of partnership goodwill.

The partners could, therefore, be faced with the prospect of finding an immediate capital sum to meet their obligations to the deceased partner's next of kin.

If they do not have sufficient liquid capital available, the surviving partners might have to borrow the necessary funds, but they would then be faced with the prospect of loan repayments for years to come. If borrowing is not a realistic option, the partners might be forced to pay a pension to the deceased partner's dependants. This would also be a long term financial drain on the partnership.

1.3 FOR THE DECEASED PARTNERS NEXT OF KIN THE PROBLEMS THAT CAN ARISE ARE:

The surviving partners may not be able to find the necessary capital immediately. Some partnership agreements allow surviving partners to spread payments to a deceased partner's estate over a number of years, up to 10 years in some cases.

The problem is compounded by the fact that the next of kin cannot sell their partnership share to any other third party. They must therefore wait for payment from the surviving partners.

2. THE SOLUTION

2.1 PARTNERSHIP INSURANCE

Partnership insurance can provide a solution to the problems outlined in Section 1 by providing liquid capital on the death of a partner to enable the surviving partners to make an immediate payment to his / her estate in respect of their share of the partnership. Partnership Insurance is arranged in two steps:

a) Partnership Legal Agreement.

Most partnerships have a written partnership agreement covering the conduct of the business and the rights and obligations of each partner. This agreement should ideally outline the precise entitlement of each partner's estate in the event of a partner's death.

b) Life Assurance.

The agreement would also normally include an **obligation on each partner to effect a life assurance plan on his / her own life for the benefit of the other partners** to provide the necessary funds on death to enable them to make an immediate payment to his / her estate.

2.2 PARTNERSHIP LEGAL AGREEMENT

The existing partnership agreement may need to be amended, or a separate agreement drafted, to provide for the purchase and sale of a deceased partner's share of the business on death.

The agreement can be framed as a Double Option agreement that provides in the event of the death of a partner:

- the **surviving partners can exercise an option** to compel the deceased's personal representatives to sell the deceased's share in the firm or
- the **deceased's personal representatives can exercise an option** to compel the surviving partners to buy the deceased's share in the firm at the market value.

If neither side exercise their options then the share is not bought back and goes through the deceased's estate to their next of kin.

2.3 FUNDING THROUGH LIFE ASSURANCE

The life assurance may be arranged in one of two ways:

a) Life of another.

Each partner covered by the legal agreement effects a **Protection Plan** on the life of the other partner. The cover on the plan should be equal to the estimated current value of the life assured's share of the partnership.

The proposer / owner of each plan will pay the premium on the plan.

The "Life of Another" method is simple and straightforward. The proceeds of the plan are, under current legislation, free from personal tax in the hands of the plan owner provided he / she has paid the premium. This method can be cumbersome where there are more than two or three partners and can be inflexible if circumstances change i.e. if a partner leaves the business.

b) Own life in trust

Each partner covered by the legal agreement effects a **Protection Plan** on their own life for a sum assured equal to the estimated current value of their share of the partnership. Each plan is written under trust for the benefit of the other partners covered by the Agreement.

Each partner pays the premium on his / her own plan.

The "Own Life in Trust" method is flexible, in that the beneficiaries can be changed if the partner leaves the business or the business protection agreement ceases. The plan proceeds will be exempt from tax in the hands of the surviving partners provided certain Revenue conditions are met. See Appendix I.

The correct approach will depend on each partnership's particular circumstances.

Example:

Partnership insurance – own life in trust method

Lets assume the partnership is valued at €1,000,000 with 3 partners as follows

Mr Quinn	40%	€400,000 Life Cover
Mr Dunne	40%	€400,000 Life Cover
Mr Hayes	20%	€200,000 Life Cover

3 own life in trust plans are effected. The premiums are paid by each partner personally (the life assured).

Mr Dunne dies

The sum assured on Mr Dunne's plan of €400,000

pays €266,667 to Mr Quinn who purchases shares from Mr Dunne's estate

and

pays €133,333 to Mr Hayes who purchases shares from Mr Dunne's estate

In line with the 'Buy / Sell' Double Option legal agreement.

The benefits of partnership insurance

- Surviving partners have funds to buy the deceased's share in the firm without having to resort to borrowing or selling assets,
- Surviving partners retain control of the business
- The dependants of a deceased partner are financially compensated

So this provides a solution to the problems outlined in Section 1.

3. TAXATION ISSUES FOR A PARTNERSHIP ARRANGEMENT

3.1 TAXATION OF PLAN PROCEEDS – LIFE OF ANOTHER

Capital Gains Tax

Capital Gains Tax will NOT apply. The proceeds of the partnership protection arrangement payable on death or disablement are not liable to CGT under current legislation.

Inheritance Tax

Inheritance Tax will NOT apply. On death the proceeds of the plan are paid to the plan owner where the arrangement has been set up on a "life of another" basis. Under current legislation there will be no inheritance tax liability for the surviving partner (the plan owner) provided he / she has paid the premium for the benefit they will receive.

3.2 TAXATION OF PLAN PROCEEDS – OWN LIFE IN TRUST

Capital Gains Tax

Capital Gains Tax will NOT apply. The proceeds of the partnership protection arrangement payable on death or disablement are not liable to CGT under current legislation.

Inheritance Tax

Inheritance Tax will NOT apply. On death the proceeds of the plan are paid to the trustee(s) of the plan for the benefit of the surviving partners.

The Revenue Commissioners have clarified that the proceeds of such a plan are **exempt from Inheritance Tax** in the hands of surviving partners, in certain circumstances, to the extent that they use the proceeds to purchase the deceased's share of the business.

More details are set out in Appendix I

3.3 SALE OF SHARES BY PERSONAL REPRESENTATIVES

The proceeds from the disposal of the share in the partnership would be liable to Capital Gains Tax in the hands of the personal representatives of the deceased. However a liability to tax would only arise on any increase in the value of the business from the date of death to the date of sale and, as such, is likely to be small.

It is important to remember that the value received for the deceased partner's share in the business could give rise to an inheritance tax liability for the deceased's family.

3.4 POSITION OF SURVIVING PARTNERS

Following the buy back, the value of the surviving partner's share of the business will increase. On a subsequent sale of the business by the survivor it is this increased value which will apply for the purposes of Capital Gains Tax on such a disposal. Any chargeable gain arising will of course be reduced by the consideration paid for the shares at the time of death. The purchase price can also be increased to allow for inflation over the period.

APPENDIX I

REVENUE CLARIFICATION ON TAXATION OF POLICY PROCEEDS

The following is an extract of a letter written by the Office of the Revenue Commissioners (Capital Taxes Branch) to the Irish Insurance Federation in June 1992:

Re: Shareholder Protection Assurance

"Essentially we are dealing here with policies which are effected purely for commercial purposes and agreed between the individual partners/shareholders on an arms length basis without any intention to make a gift.

The Revenue approach to such policies, written in the form of own life in trust for others, is to treat the proceeds as exempt from Inheritance Tax in the following circumstances: -

- Proceeds on death will be used to purchase deceased's shareholding. Any surplus arising will be liable to Inheritance Tax.
- The capital sum under each policy will reflect the policyholder's shareholding.
- Payment of premiums will be made by the individual members, or on their behalf by the company or partnership out of the individual's own company or partnership account.
- New partner(s)/shareholder(s) can join the arrangement at any time, subject to the conditions applicable to the existing members of the plan.
- On withdrawal from the company or on retirement, the policy of the partner who leaves will revert to himself and he will no longer benefit in the continuing arrangement, provided he sells his shareholding on withdrawal, otherwise he can remain a party to the arrangement. Such policy will be an asset in his estate on his death and will not be exempt from Inheritance Tax.
- On the death of a sole surviving partner or shareholder the policy on his life will be an asset in his estate and will not be exempt from Inheritance Tax. Similarly, if a partnership breaks up or a company is wound up, policies, which do not lapse, will be liable on death to Inheritance Tax.
- Where a partner refuses to join the arrangement or is unable to effect life insurance on medical grounds, then he will be precluded from benefiting from the policies of his co-shareholders.
- The insurance policies can either be Term Insurance, Endowment or Whole of Life policies, with the Death Benefit only passing to the surviving shareholders.
- Company Directors/Partnership Insurance using Own Life in Trust must be supported by relevant documentation:

  (a) Buy/Sell (or Double Option) Agreement.

  (b) Reciprocal Agreement.

  (c) Trust Document.

We advise that your client seeks professional tax and legal advice as the information given is a guideline only and does not take into account your client's particular circumstances.