Business Protection

Payment Equalisation

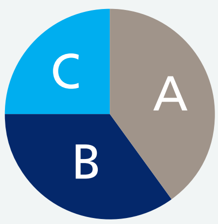
As part of effective business succession planning, business owners may choose to take out life assurance to enable the remaining owners to buy their share of the business from them or their beneficiaries upon their death or after suffering a critical illness. For this arrangement to work, the policy will need to be written in trust with an appropriate option agreement in place.

The cost of each individual's policy is likely to vary due to the following:

- the business owner's age,
- the business owner's health (including smoking status),
- the sum assured required (if they own different proportions of the business).

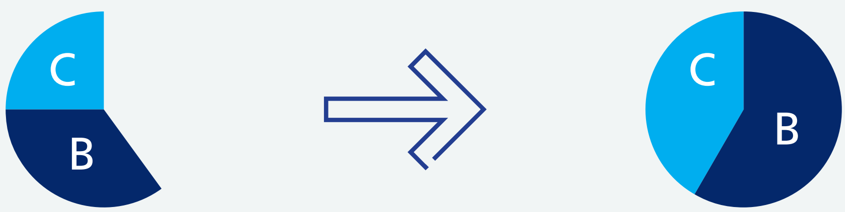
The need for 'payment equalisation' usually occurs as those who are least likely to benefit, say due to their age or health, are the people that will pay the highest payments. It is also to ensure the arrangement is viewed as 'commercial', which is essential for tax purposes.

Let's look at an example: ABC Ltd. is owned by three shareholders with the following shareholdings and life assurance payments. There are 100 shares in ABC Ltd.



Shareholders	Age	Shares	Payment
A	45	40	£500
B	55	35	£1,000
C	40	25	£200
Total		**100**	**£1,700**

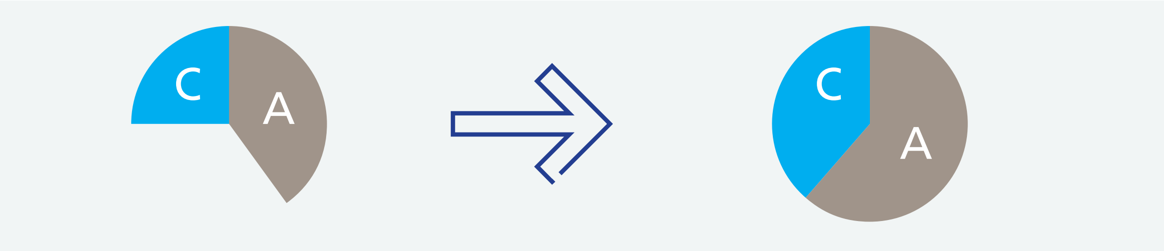
If A died, it has been agreed that the surviving directors B and C will purchase A's shareholding in proportion to their own shareholding. Therefore, if A was no longer part of the business, B would own 35 out of the 60 remaining shares and C would own 25 out of the 60 shares. So B would receive 35/60ths of A's share and C would receive 25/60ths of A's share. To ensure the arrangement is fair, they should pay the same proportion of the payment as the share they will receive. So...



A's payment is £500, therefore B should pay £500 x 35/60 = £291.67
and C should pay £500 x 25/60 = £208.33

If B died, the same would apply for the other shareholders.

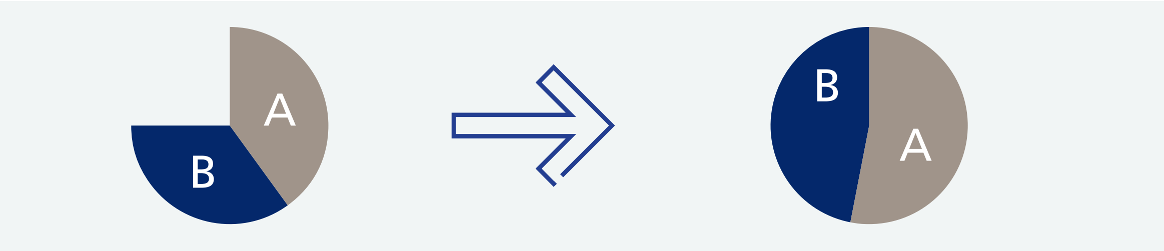
If B was no longer part of the business, A would own 40 out of 65 shares and C would own 25 out of 65 shares. So A would receive 40/65ths of B's share and C would receive 25/65ths of B's share.



B's payment is £1,000, and so A should pay £1,000 x 40/65 = £615.38
and C Should pay £1,000 x 25/65 = £384.62

Again, the same would happen if C died.

If C was no longer part of the business, A would own 40 out of 75 shares and B would own 35 out of 75 shares. So, A would receive 40/75ths of C's Share and B would receive 35/75ths of C's share.



C's payment is £200, and so A should pay £200 x 40/75 = £106.67
and B should pay £200 x 35/75 = £93.33

Payments would be made as follows.

	A's payment	B's payment	C's payment	Total	Difference from original payment
A pays	–	£615.38	£106.67	£722.05	£222.05
B pays	£291.67	–	£93.33	£385.00	(£615.00)
C pays	£208.33	£384.62	–	£592.95	£392.95
Total	£500.00	£1,000.00	£200.00	£1,700.00	–

The business owners will need to balance the payments between themselves. In the above example, A needs to pay B £222.05 and C needs to pay B £392.95. These amounts are the difference between their payments to their own policies and what they need to pay under payment equalisation.

How is payment equalisation affected if the company or partnership makes the payments?

Another way of providing for the equalisation would be for the company to pay the entire cost of all three policies from the company bank account and for the company to debit the appropriate equalised amount from the post tax salary/loan account/capital account from each shareholder.

If the parties were partners then a similar 'composite' payment could be made from the partnership bank account and the appropriate amounts debited from the partners post tax current, capital or loan accounts.

It is essential that any business considering implementing a payment equalisation arrangement seek the advice of their accountant with regard to its use, tax, and national insurance consequences and then documents and administers the arrangement clearly and carefully.

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