



Shareholder protection

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An overview

BRIEFING NOTE

Business protection series

The shareholder business protection plan

The death of a director on surviving co-directors

Your Company's Articles of Association or Partnership Agreement should contain a clause explaining that on death your shares pass to your 'personal legal representatives', usually your family.

However, these documents commonly state that the remaining Directors/Partners have a right to acquire your shares within a stated period, eg six or twelve months after death, failing which your shares pass to your family.

The Articles will also usually make mention of establishing "fair value" for the shares and this is where problems often arise. Lawyers acting for your family will wish to maximise the value, while the Company's lawyers and accountants will seek to minimise the value.

This can be a lengthy process. While business Colleagues will usually have a good working relationship in life, on death relations between your family and your former Colleagues can polarise as positions become legally (and expensively) entrenched.

If an agreed value cannot be reached, the Articles or Partnership Agreement will normally prescribe that an independent adjudicator is appointed (e.g. an Accountant) to establish 'fair value'- usually a small fraction of the value of your shares when you were alive.

Upon the death of a shareholder, the surviving shareholders run the risk of the shares passing to someone with no interest in the Company, or even to another company that might then be in a position to make a takeover bid.

Most Directors/Partners in this situation will want to buy the deceased's shares and keep control of their Company, but very few will have the right amount of cash available at the right time.

Some businesses may turn to their bankers, but many have existing loans that would rule out further advances. Also a crisis, such as the death of a senior colleague, can create uncertainty and instability within a company, so banks will be less willing to lend.

If it were YOUR Family, surely you'd prefer them to receive 'FULL VALUE', and as quickly as possible?

Or, if it were YOUR Company, wouldn't it be preferable to retain full control and be forever on comfortable terms with your late Colleague's Family?

The benefits of the shareholder protection plan

Most Articles of Association or Partnership Agreements allow surviving shareholders to purchase a deceased Colleague's shares, *but few firms put in place the mechanism to facilitate the transaction.*

The Shareholder Business Protection Plan is the mechanism to give:

The deceased colleague's family

- ✓ A known financial amount for their inherited shares
- ✓ Quicker access to the funds from the value of those shares

The continuing directors

- ✓ Funds available, without the need for bank borrowing
- ✓ Control of the business swiftly going forward.

The business shareholder protection plan details

There are three components to our suggested Plan:

- i) A Cross Option Agreement
- ii) Life assurance policies
- iii) A Business Trust

All Participants in the Plan:

- ✓ are parties to the Cross Option Agreement
- ✓ effect life assurance policies
- ✓ are trustees (and beneficiaries) of the Business Trust

Participants will typically be shareholding directors, but can include other beneficial shareholders.

How are the purchase funds provided?

A life assurance policy is affected on each participant's life.

The Cross-Option Agreement states that each participant shall, no later than one month after the date of the Agreement, effect a life assurance policy.

What price for the shares?

In theory, their "open market value". However the very reference to "open market" means that such a value has to be formally established.

This can cause delay in the completion of the sale and purchase, and can be the issue that means the arrangement is delayed or even never executed.

The answer can be to elect a fixed value for the shares for the purpose of using a Cross Option Agreement. This ensures that the appropriate level of life assurance cover can be affected.

How does the agreement operate?

- The Agreement stipulates that, on the death of a participant, the deceased's family have the option to sell their shares to the surviving participants and the surviving participants have the option to buy the deceased participants shares from the family.
- If an option is exercised by either party then both parties are bound by that option.
- The remaining participants can exercise their option to buy the shares at any time within three months of the date of death.
- The family can exercise their option to sell the shares at any time within six months of the date of death.

Why is the Agreement not a binding contract for Sale?

Under current legislation many shares will qualify for 100% Business Property Relief for Inheritance Tax.

However, 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.

A Cross Option Agreement however is not a binding contract for sale and therefore Business Property Relief is preserved.

How long does the Agreement last?

The Agreement can last indefinitely but regular reviews should be carried out to ensure the amount of cover under the life assurance policies continues to reflect the actual value of each participant's shares.

- We would usually suggest (guaranteed) renewable life cover for a term of 5 years.
- The terms in years can be varied to suit individual circumstances.
- The shorter the initial term, the less expensive at start, although the faster the premiums rise in the future, as each guaranteed renewal date is subject to the new premium for the given age of the shareholder at that time.

Who should pay the life assurance premiums?

- Each participant undertakes to pay premiums on his/her own life. This may not be equitable because of different ages and sums assured and, if desired, the company can adjust the premiums to compensate for this.
- Normally, the company pays the participants' life assurance policy premiums, thus ensuring all policies are in force at all times.
- When the company pays the premium on behalf of the participants this will be a "benefit in kind" and the participants will become liable for Income Tax on the premiums relating to their own policy.
- Individuals can opt to pay their own premiums if they prefer (e.g. if dividend income is preferred from the business, avoiding a benefit in kind would avoid additional Class 1A National Insurance Contributions (NICs).
- Although a system of premium equalisation can sometimes be undertaken by the life office, so that each participant bears the same cost equal in proportion to their shareholding, this may be more costly as the best priced cover might be with a life office that does not offer this facility.

The business trust

- Each life assurance policy will be subject to a Business Trust for the benefit of the other Participants.
- The proceeds of the life assurance policy when arranged under the Business Trust will be payable to the trustees (continuing participants) free from Inheritance Tax, since they do not form part of the deceased's Estate.
- The Estate of the deceased shareholder includes the shares and not cash, thus preserving Business Property Relief on the value of the shareholding.

When shareholding Directors die, the shares they held pass to their legal beneficiaries, usually their family.

In these circumstances often the most desirable outcome is that the remaining shareholders buy the deceased colleague's shares.

The bereaved family is thus properly compensated for the full value of their shares.

Peace of mind for your family - a clear future for your company.

What about inheritance tax?

Provided that all eligible individuals participate, there will be no Inheritance Tax on the life assurance policy premiums as it will be considered to be a bona fide commercial arrangement.

If for some reason this were not the case, life assurance premiums would usually fall within one or more of the Inheritance Tax exemptions.

The proceeds of the policies do not form part of the deceased's estate and will go to the trustees(continuing participants) of the Business Trust free from Inheritance Tax.

What about capital gains tax?

There is no Capital Gains Tax on death.

The beneficiaries of the deceased's estate could be liable to capital gains tax on any increase in value of the shares between the death and the sale, although in practice this would be rare.

Can shares be sold during my lifetime?

Your company's Articles of Association should govern this but the provisions detailed in the Cross Option Agreement will not in any way prevent any sale or other disposal of a participant's shares during his/her lifetime.

The Cross Option Agreement only covers share transfer on death of the shareholder.

What about a company buy-back of the shares instead?

This is less often preferred, as there are potential problems with newer shareholders.

In this instance, the company takes out a plan on the life of each shareholder to the value of their shareholding. If a shareholder dies, the company buys the shareholder's shares, which are then cancelled and revert to un-issued share capital.

For cover to be taken out in this way:

- The shares should have been owned by the shareholders for at least 3 years for a sale by their personal representatives. If less, there may be a substantial income tax liability for the shareholders or their estates when they die.
- The articles of association must let the company purchase its own shares.
- The requirements for company share purchase under the Companies Act must be met.

Tax:

- The company will pay the premiums, which won't be deductible as a trading expense.
- The premiums won't be subject to income tax or National Insurance.

To review your businesses needs

We hope you found this Briefing Note of interest. As usual with such matters, often more questions are raised than answered. Therefore, for a complete costing and bespoke plan for your needs, please contact Edward Mills, our MD who personally specialises in this area of advice at Patterson-Mills.

You can find out more information about business risk on our website at:

<http://pattersonmills.com/business-protection/>

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