

COMPANY SHARE BUY BACK GUIDE.



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Mortgage and Protection Advisers

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INTRODUCTION.



The purpose of this guide is to explain in plain English how a company share buy back arrangement operates.

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

The guide describes a possible method of shareholder protection that involves life insurance (and where selected, critical illness policies) and a written agreement between a company and its shareholders.

The guide has been drafted on the basis that the company concerned is an unquoted, private company limited by shares and registered in England & Wales and that any share purchase is 'off-market' (as defined in section 693 Companies Act 2006).



▶ WHAT IS THE AIM OF THE AGREEMENT?

A company share buy back arrangement aims to provide a company with a way of buying shares from a shareholder on his or her death. Such an arrangement can provide a deceased shareholder's estate with a buyer for the shares where a

market for them might not ordinarily exist. The arrangement can also provide the company with the funds with which to purchase the shares and a legal option to do so. Similarly, provisions can be put in place for a shareholder's critical or terminal illness.

HOW DOES THE ARRANGEMENT WORK?

The arrangement consists of:

- 1 – A life insurance policy (with appropriate benefits selected) on the life of each shareholder from whom the company would wish to purchase shares. The application would be proposed by the company on the life of the shareholder. Any resulting policy would be issued to the company as grantee and policy owner.
- 2 – An agreement entered into between the company and the shareholders. The agreement would provide legal options to the company (and possibly the shareholder or his or her estate) in the event of the death (or critical or terminal illness) of a shareholder.

WHY IS AN AGREEMENT NEEDED?

Without an agreement, upon the death of a shareholder the company and its surviving shareholders have the prospect of the deceased's shares passing to someone with no interest in the company, or even to someone with a competing interest.

The articles of association should stipulate what happens on the death of a shareholder. Usually the shareholder's personal representatives and subsequently the beneficiaries of the estate will become entitled to the shareholding.

Unless the deceased shareholder owned a majority of the shares it may be that the recipient of those shares finds that they provide very little benefit. Sales of shareholdings to outsiders may be restricted and a sale to the continuing shareholders may only be possible if funding has been arranged in advance. This could mean that the family of the deceased shareholder may not receive the best price for their shareholding or indeed not find a buyer at all.

Most surviving shareholders will want to keep control of the company. One option is for the company to buy the shares from the deceased shareholder's estate. Will, however, the company have the cash available to do this? The company may consider asking for a bank loan, however, any existing loans may rule out further advances. Also, a crisis such as the death of a shareholding director may create uncertainty and instability within the company such that banks will be less likely to be willing to make a loan. Even if the company has some money it may still not be sufficient, especially when taking into account the issues surrounding the general requirement for a company to maintain share capital.

A possible solution is forward planning through the company owning a life insurance (and Critical Illness Cover – if selected) policy on the life of each shareholder.

(Other shareholder protection methods are available. Please see our Guide to Share Protection for a different method of shareholder protection.)



HOW DOES THE AGREEMENT OPERATE?

The agreement is able to include options for death and, if required, critical illness. The agreement should indicate which events the parties wish to plan for and this should be reflected in the type of policies that are being arranged. An agreement may be made along the following lines:

Death

On the death of a shareholder, the company has the option to buy the shares of the deceased shareholder from the personal representatives of the deceased. If the option is exercised, the personal representatives must sell the shares. The company can exercise its option within a period specified in the agreement, for example, within three months of the date of death.

Terminal or critical illness cover

On the terminal or critical illness of a shareholder, the company has the option to buy the shares of the ill shareholder within a period specified in the agreement, for example, within three months of the receipt of the policy proceeds.

Often such an agreement will not include an option for the shareholder or his or her personal representatives to sell the shares to the company. The reason for this is that it may not always be possible for the company to purchase the shares.

The result will be a 'single option' agreement rather than a 'cross option' agreement. Clearly, this provides no certainty for an ill shareholder (or the personal representatives of the deceased shareholder) that he will be able to sell the shares to the company.

Under the agreement, the company can agree to effect and maintain a life insurance policy (and critical illness cover if agreed) to provide the required amount of money to purchase the shareholding.

The company will need to comply with certain company law requirements in order to repurchase the shares. Subject to this, once the shares have been repurchased they will be cancelled (though in some circumstances they may be held in treasury). The effect of this is to increase the shareholding of the remaining shareholders in proportion to their previous shareholdings.

CASE STUDY

Rex Bosco, Monica Young and Chris Marsh directors in Monk Construction Company Limited.

The current shareholdings are as follows:

Shareholder	Shares	Value	Percentage of total shares
Rex Bosco	40	£200,000	40%
Monica Young	20	£100,000	20%
Chris Marsh	40	£200,000	40%

The company effects a life insurance policy on each of Rex Bosco, Monica Young and Chris Marsh with a sum assured equal to the value of their shareholding.

The company and the shareholders enter into an option agreement.

If Monica Young were to die and if the company were to purchase her shares from her personal representatives the shareholdings would be as follows (following the cancellation of the repurchased shares):

Shareholder	Shares	Percentage of total shares
Rex Bosco	40	50%
Chris Marsh	40	50%



▶ PRACTICAL CONSIDERATIONS.

WHAT PRICE IS TO BE PAID FOR THE SHARES?

It is important that when putting an option agreement in place an appropriate method is agreed as to how the shares are to be valued. Once in place, it is important the arrangement is reviewed regularly to check that it is still appropriate for the circumstances of the parties. This should also provide a good opportunity to review the life and critical illness (if selected) policy.

It is important to note that the proceeds of the life policy will increase the cash balance of the company and therefore the value of the shares. This needs to be factored into the amount of life cover selected.

HOW LONG CAN AN AGREEMENT LAST FOR?

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

HOW ARE THE FUNDS TO MAKE THE PURCHASE PROVIDED?

A life insurance or life insurance and critical illness policy is written on a 'life of another' basis with the company as the owner and the shareholder as the life insured. If there were a death/critical illness claim, the proceeds of the policy would be paid to the company to enable it to buy the shares.

WHO SHOULD PAY THE PREMIUMS?

It would be expected that the company would pay the premiums. The company will own the policy and as such the premiums would be unlikely to constitute a taxable benefit for the life insured.

WHAT TYPE OF POLICY SHOULD BE EFFECTED?

This will depend upon individual circumstances and what can reasonably be afforded. For example, if a shareholder is a director of the business and it is not known when he or she will retire, a whole of life policy rather than a term policy could be considered.

WHAT IF THE AMOUNT OF COVER DOESN'T MATCH THE PRICE TO BE PAID FOR THE SHARES AS SPECIFIED IN THE AGREEMENT?

If there are regular reviews of both the agreement and the policy it is likely that the proceeds of the life policy will match the price to be paid for the shares. An option agreement could make provision for the possibility of the proceeds being more or less than the agreed valuation of the deceased's shares.

WOULD AN AGREEMENT PREVENT A SHAREHOLDER FROM SELLING ANY OF HIS/HER SHARES DURING THEIR LIFETIME?

The articles of association should govern this. It is possible for the option agreement to allow this and it will not in any way prevent any sale of other disposal of the shareholder's shares during his lifetime.

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

It will be important to encourage the shareholders to review this agreement with their legal advisers.

CAN ANY BUSINESS PROPERTY RELIEF BE PRESERVED?

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

However, if the company share buy back agreement in force were a binding contract for sale, such as a buy and sell agreement, any Business Property Relief would likely be lost. This may not be important if the shares are to pass on death to the shareholder's spouse or civil partner where an Inheritance Tax exemption applies (assuming UK domicile). Nevertheless, this exemption should not be relied upon as the spouse or civil partner may die before the shareholder. Consequently, if a binding agreement for sale were in place, further Inheritance Tax planning might be required.

A properly drafted option agreement, however, is not a binding contract for sale. Therefore this method should preserve Business Property Relief. (This method simply gives the company an option to buy the deceased shareholder's shares.)



COMPANY LAW AND TAXATION CONSIDERATIONS.

The company law and tax considerations of a share buyback can be complex, and will require specific legal and tax advice. Below is some general information from which to make further enquiries with your legal and tax advisers.

COMPANY LAW

A private limited company may purchase its own shares, but only if it meets certain requirements:

- a) The company's articles must not prevent it, and
- b) The relevant provisions of the Companies Act 2006 must allow it in the circumstances, and the procedures contained must be followed.

Some key requirements to enable a private limited company to purchase its own shares include:

- The shares must be paid for on purchase.
- The shares being purchased must be fully paid.
- After purchase, the shares must be cancelled or held in treasury.
- After purchase there must still be issued share capital (other than redeemable shares or treasury shares, making this method of share protection unlikely to be appropriate for a company with a single shareholder).
- The payment must be funded, firstly, from distributable profits (or proceeds of a fresh issue of shares made for the purpose of financing the purchase), but once exhausted may come from capital.
- There must be a contract to buy back the shares, the terms of which must be approved (in advance of the purchase) either by an ordinary resolution, or, if the purchase is to be funded from capital by a special resolution. In either case, the resolution must follow the prescribed procedure for disclosure, which will vary depending on the type of resolution.
- Where the purchase is to be funded from capital, there are additional steps to take, including that: the director's must make a statement, reviewed by an auditor, confirming that the company will be able to carry on business for the next year; and, notice of the proposed payment is to be given in the Gazette and a national newspaper.

It is essential that the relevant company law legislation is followed to ensure that the share buyback is effective. Failure to honestly follow the correct procedures can be a criminal offence.

INHERITANCE TAX

Where the company is paying premiums on its policy there should be no Inheritance Tax due in relation to the premiums. Since the company owns the policy, the proceeds should not be in the estate of the deceased and therefore should not be subject to Inheritance Tax.

The shares of the company will likely be in the estate of the deceased; but, if those shares qualify for Business Property Relief of 100%, or a spousal exemption applies, no Inheritance Tax will be payable on them. Where Inheritance tax is likely to be payable, it is worth considering whether the receipt of the policy proceeds will increase the share value (and therefore any potential Inheritance Tax liability) in the estate of the deceased.

CORPORATION TAX

It is not expected that the company would receive corporation tax relief on the payment of the policy premiums. It is also not expected that the payment of life or critical illness benefits would be treated as a trading receipt by the company for corporation tax purposes.

The 'loan relationship' rules are unlikely to have a significant impact, as the current range of Legal & General term and critical illness policies are not capable of acquiring any surrender value.

CAPITAL GAINS TAX AND INCOME TAX

Generally, where shares are re-purchased by a company, there is a distribution by the company to the extent that the purchase price exceeds the amount originally subscribed for the shares. This distribution will usually be subject to income tax.

Where the company concerned is an unquoted company, it may be possible for this excess to be treated as capital, which can reduce the amount of tax payable. Certain conditions need to be met by both the seller and the buyer, but where all or most of the payment from the company is used for the payment of the seller's Inheritance Tax liability as a result of death it may be possible for some of these conditions to be waived.

It is possible to apply to HMRC in advance for confirmation that the purchase will not be treated as a distribution ('advance clearance'). HMRC clearance would need to be sought for the transaction in any event.

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