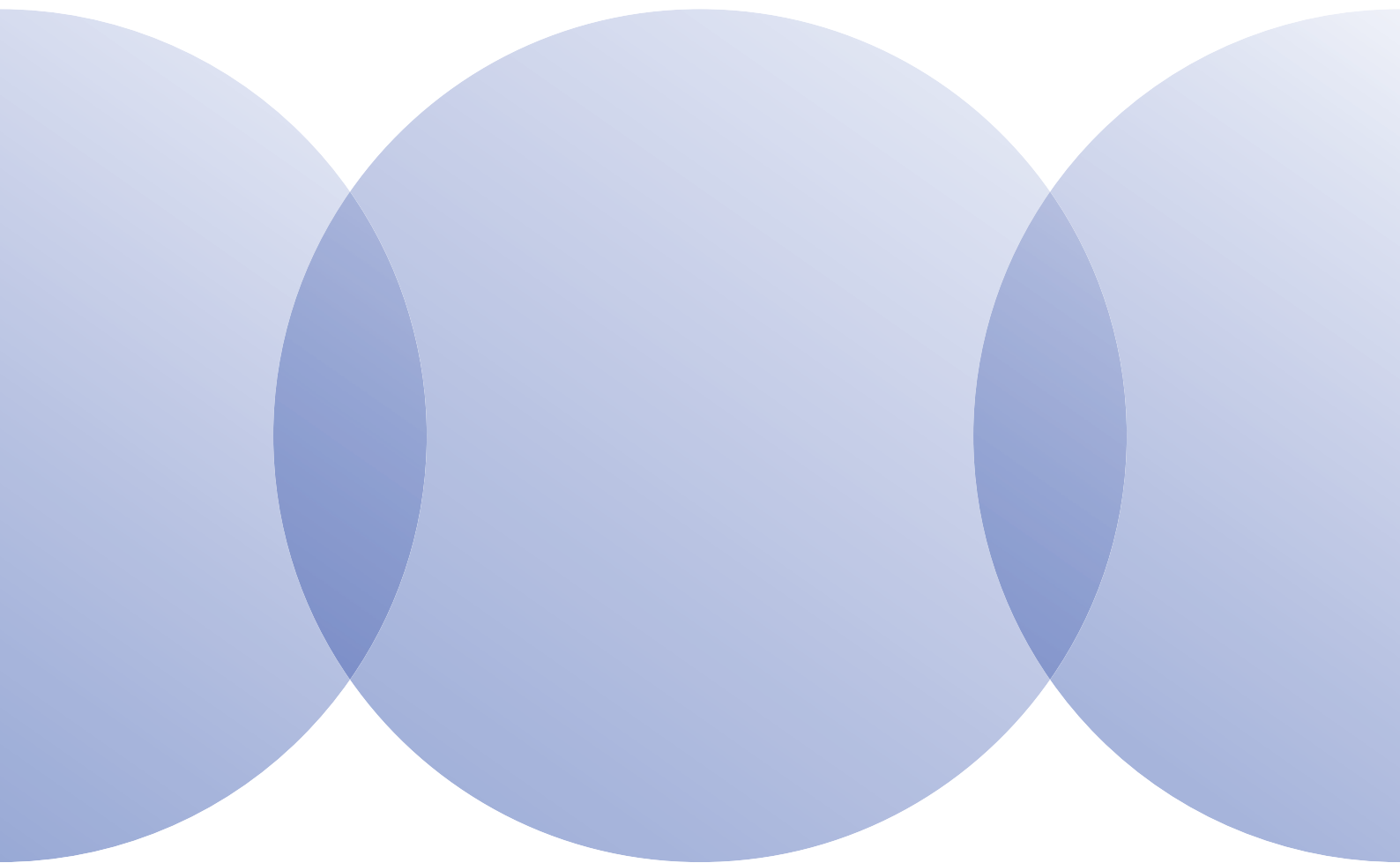


Draft Double Option Agreement  
for company share purchase following  
the death of a shareholder



This option agreement is provided in draft form for consideration by your legal advisers. They must undertake the responsibility to ensure that it takes into account your individual circumstances and requirements and the terms of any existing documents and agreements relating to your business.

Therefore, you need to contact your legal adviser.

#### Why is this a draft agreement?

You should not simply fill in the form – Zurich doesn't know enough about your business to be sure that this agreement will work for you and your business as a whole. It might be unsuitable because, for example, there is a specific provision in your Articles of Association or a shareholder agreement about sale and purchase of shares, and completion of this agreement in its present form may conflict with that provision. In addition, this agreement may not reflect what the business owners might have wanted to happen when a co-owner dies.

#### Important note

This draft agreement is based on our understanding of current law and HM Revenue and Customs' practice (Sept 2010). Although every care has been taken in the preparation of the draft agreement, neither Zurich Assurance Ltd nor any of its officers, employees or agents accept responsibility in respect of its suitability for you. Therefore it must be referred to your own legal advisers to ensure it meets your requirements.

### **What is it?**

It is an agreement between a limited company and one of its shareholders which provides that if the shareholder were to die, the company would have the option to buy the deceased's shares in the company and the personal representatives of the deceased shareholder would have the option to sell the deceased's shares back to the company.

### **How does a company purchase of its own shares work in practice?**

It is possible for a limited company to purchase the deceased's shares, provided this is not forbidden in the Articles of Association and subject to satisfying certain company law requirements (see Frequently Asked Questions below). Once purchased, the shares are then cancelled. The result is that the proportions in which the remaining shareholders own the company are correspondingly increased.

A company share purchase is an alternative to a business succession plan involving the shareholders themselves entering option agreements for the sale and purchase of the company shares and effecting life plans subject to business trusts.

With a company share purchase, the company itself would effect a plan on the life of the shareholder to fund the potential purchase. No trust will be necessary.

### **Aims of the draft agreement**

Broadly speaking, the option agreement specifies the terms on which a sale and purchase of a deceased shareholder's shares in the company can take place.

If the intention of the business owners is for similar terms to apply in respect of all the shareholders, a separate agreement needs to be made in respect of each shareholder.

The overall effect of the arrangement is to ensure that the deceased's spouse/civil partner, or other dependants can receive cash in exchange for the deceased's shares in the company (which are cancelled on purchase) and the company can, as a result, remain wholly owned by the surviving shareholders.

### **When should this draft agreement be used?**

As already mentioned, it may be used by those with shares in a limited company and where a share purchase by the company is possible under the company's Articles and under company law.

It should, however, only be used to deal with the sale and purchase of shares following a shareholder's death. Zurich provides a separate draft option agreement to cover business share sale and purchase following a shareholder's critical illness.

As for all of the draft documents made available by Zurich, potential users should carefully check the document's appropriateness with their professional advisers before use or adaptation. The option agreement is provided on this strict understanding.

### **When should this draft agreement not be used?**

We reiterate that this is a draft agreement, and it should not simply be filled in. It should be referred to your legal adviser to check whether it is suitable in its current form. If it's not, it shouldn't be used.

Professional advice is essential especially as the possibility of a purchase needs to be verified against the Articles and any other shareholders' agreements. In addition, compliance with company law must be ensured.

As stated above, this draft agreement should not be used in conjunction with critical illness plans.

### **How is a double option agreement established?**

As is made clear above, this is a draft agreement, and so it should not simply be filled in. It should be referred to your legal adviser to check whether it is suitable in its current form.

If the agreement is found to be suitable for your business, the following needs to be completed (there are 5 parts and all parts that need to be completed are in blue shaded boxes):

#### **On page 1 of the draft agreement**

- It has to be dated
- Full name and address of the shareholder needs to be inserted
- The name of the company and its registered address need to be inserted.

#### **On page 2 of the draft agreement (section 3)**

- If you wish to specify the value at which your shares are to be purchased under the agreement you need to state (in (i) and (ii) of section 3) how long that specified value will hold good for. The minimum is 1 year and the maximum is 3 years. The potential tax consequences of choosing a 'specified value' and the relevance of the period for which it is to operate are explained in the 'Frequently Asked Questions' section.

#### **On page 3 of the draft agreement (section 5)**

- You should (in (i)) fill in the number and frequency of instalments where the plan proceeds are less than the value to be paid under the agreement (see 'Frequently Asked Questions')
- You should (also in (i)) indicate (by entering 'x' in the appropriate box) whether or not instalments should be subject to payment of interest (and, if they are, enter the rate of interest that will apply)

#### **On page 4 of the draft agreement**

The shareholder should sign the agreement, and have their signature witnessed. The address of the witness also needs to be included. Two officers of the company (other than the shareholder) also need to sign. Alternatively, one officer's signature is sufficient if the company seal is available.

#### **On page 5 of the draft agreement (Schedule – Specified Value)**

Insert the specified value (if appropriate). Please see 'Frequently Asked Questions' for more information about 'specified value.'

# Frequently asked questions

## **What are the legal requirements that need to be satisfied before a company can buy its own shares?**

The following are the main requirements under the Companies Act 2006 .

- Company's Articles should not restrict or prohibit a purchase of own shares.
- The share purchase must not leave the company with only redeemable and/or treasury shares.
- A private company must use distributable profits to purchase the shares before it can resort to capital.

Additional safeguards are required where the purchase is to be made out of capital (see below).

## **What are the additional requirements if the purchase is to be made out of capital?**

The following are necessary:

- Directors' statement about the solvency of the company and an auditor's report that the statement is not unreasonable
- Special resolution by the shareholders
- Publicity: ie. a notice in the London Gazette and a national newspaper.

Professional advice will be necessary at the time of purchase to ensure compliance with all the requirements.

## **How should the funds necessary to enable the company to purchase the shares be provided?**

It is expected that the company will effect a life assurance plan on the life of the shareholder. The company must have the power to effect any life plans and sufficient insurable interest in the person on whose life the plan is effected (both would normally exist).

## **Can it be guaranteed that the company will be able to use the proceeds of the plan to buy the shares of the deceased shareholder following the shareholder's death?**

No. As indicated above, there is a requirement that the directors must be able to give a (justifiable) statement of solvency as one of the conditions of company share purchase. In addition, there is a requirement to publicise the intended purchase. Clearly where a company has substantial debts, not only will the giving of the required solvency statement be difficult or impossible but also the company's creditors may well object to the company capital being spent on share purchase if this could, in their view, prejudice their interests.

Any shareholder or creditor can apply to the court for cancellation of the resolution approving the purchase of the company's shares out of capital. Therefore there can be no absolute guarantee on this.

## **Are there any special requirements concerning the actual purchase?**

Yes. There are time limits within which the share purchase must take place.

Various statutory forms must be completed and delivered to the Registrar of Companies.

Copies of the contract must be available for inspection for a period of 10 years after completion of the contract.

It is important to remember that the shares purchased must be fully paid up and the consideration for the shares must be paid by the company immediately in money ie. payment by instalments is not possible.

Following the share purchase, the shares purchased by the company must be cancelled, thus reducing the issued share capital.

It is reiterated that professional advice will be essential at the time of purchase.

**Can the proceeds of the plan that is taxed as a capital receipt be classified as distributable profits?**

Although a life plan (and its proceeds) is normally regarded as a capital asset, general opinion is that the proceeds could be treated as distributable profits although it will be essential that the company seeks appropriate professional advice at the relevant time on this matter.

However, even if the plan proceeds do not fall within the definition of distributable profits then a private company could still resort to capital to buy back the shares although, as stated earlier, this would involve satisfaction of more formalities.

**What happens if the shareholder suffers a critical illness?**

This draft option agreement does not cover this eventuality.

Zurich provides a separate and additional draft agreement ('The Zurich Draft Option Agreement for Purchase on Critical Illness') to cover situations where business owners suffer a critical illness. We keep the death and critical illness situations separate, as not all businesses require critical illness cover, and not all individuals in the business are able to secure critical illness cover.

**What happens if one of the shareholders leaves the business, other than by dying?**

This will not affect the agreement between the company and the other shareholders.

**What happens if a new shareholder joins the business?**

If it is intended that his shares are also to be purchased by the company on death, a similar agreement will need to be executed with that shareholder. Any agreements with existing shareholders will not be affected.

**What happens if the shareholder disposes of, makes subject to a charge or deals in any way with his or her shares?**

The draft agreement states that this should not happen without the consent in writing of the company.

**What happens if, after the death of a shareholder, the surviving directors running the company decide that they don't want the share purchase to proceed in the way agreed, or perhaps if the deceased's spouse or civil partner wants instead to become involved in the company's business?**

If either the deceased's personal representatives or the surviving business owners running the company decide that they want to exercise the option to sell/buy the deceased's shares, then the agreement becomes binding regardless of what the other party may wish to do. So, if for example, the surviving company directors wish that the company should buy the deceased's shares, then the purchase will proceed, irrespective of the personal representatives' wishes.

**How is the price that should be paid for the shares decided, if the shareholder dies?**

This is fully covered in Section 4 of the draft agreement. There are 3 options:

1. If the shareholder enters a 'specified value' as part of the agreement, that value will apply for the period specified unless a new value is specified and recorded in a Memorandum executed by the shareholder and the company.
2. At any time but not later than every one to three years (as specified), the shareholder and the company can replace that specified value with a new one, by executing a Memorandum.
3. In all other cases a fair market value will have to be established by an appropriate third party at the time the purchase is to take place. The tax implications of an arrangement based on a specified value are covered at the end of this section.

**When a shareholder dies, can the remaining shareholders, rather than the company, purchase the shares?**

It is possible for the shareholders themselves to enter into similar option agreements and in such cases the surviving shareholders will have the option to purchase the shares and the deceased's personal representatives will have the option to sell.

There are different tax and legal consequences of each route. Both routes should be fully explored by the business owners before deciding between the personal and corporate route.

A sale to the continuing owner(s) in their individual capacity is more complex to set up initially as it involves trust arrangements but the actual share purchase following death is generally easier to carry out as there are fewer legal formalities to comply with, compared with the corporate route.

**Do the business owners need to make a will?**

This is not essential but is highly recommended. Where a valid will is in existence the deceased's shares can be dealt with under the agreement more quickly.

**Does the company have to take out an accompanying life assurance plan?**

Not having a life assurance plan in place doesn't mean that an option agreement can't be established.

However, a life assurance plan is an appropriate method of ensuring that the company has the financial means to purchase the interest of the deceased shareholder.

**What happens if there is no life assurance plan in force when a shareholder dies?**

If a sale/purchase of the deceased's shares is to take place, the company will have to seek other means of accessing or raising the funds to effect the purchase.

**What happens if the proceeds of the life assurance plan are insufficient to completely buy out the deceased's shareholding?**

The draft agreement makes provision for this in section 5 by requiring that the shortfall be made up by the payment of equal instalments over an agreed period of time. The parties to the agreement might decide that interest should be payable (and if so determine the rate of interest) or allow interest-free instalments. Specifying a value and insuring for this amount can prevent this happening.

**What happens if the proceeds of the life assurance plan exceed the value needed to purchase the whole of the deceased's shareholding?**

Once again, the draft agreement makes provision for this. The surplus is retained by the company. Again, a specified value and equivalent insurance can help avoid such a surplus arising.

**How quickly will the purchase proceed when a shareholder dies?**

It depends on the parties involved, but under the agreement the option to sell operates for six months from the date of the shareholder's death and the option to buy for three months. In both cases the option can be exercised within one month of obtaining the grant of representation if later. The different terms are there to support the position that the agreement is not, in effect, a binding contract for sale/purchase. Compliance with the relevant legal requirements (outlined earlier) at the time and obtaining the relevant clearances will also of course impact on the timescale.

# What are the tax consequences of the draft double option agreement?

## Inheritance tax

Provided the arrangements made between the parties to the agreement demonstrate that there is no gratuitous intent, they are commercial and demonstrably on terms that one would expect to see made between unconnected parties there should be no adverse inheritance tax (IHT) consequences to entering into the agreement.

Ensuring that the arrangement is on commercial terms is particularly important where a specified value is to be used for the purchase of the business interest. 'Commerciality' will be reinforced where each party is independently and professionally advised as to the value of the shares to be bought/sold under the agreement.

The existence of an option agreement on commercial terms does not usually affect the IHT position when a shareholder dies.

Although the value of the shares will be added to the deceased's estate on death (usually at the value specified or otherwise determined by the agreement) business property relief would normally apply where the business is a trading business and there should be no IHT on death.

The availability of business property relief or otherwise will however be dependent on the facts and cannot be guaranteed. The risk of failing to qualify for business property relief will be significantly diminished where the agreement and intention of the parties reflects the fact that a sale and purchase under the agreement is not a foregone conclusion.

## Capital gains tax

If a value is specified in the agreement then it is important that it is based on the current open market value of the business interest, and that:

- the term for which the specified value will hold good does not exceed three years, and
- a professional business valuation at the time of entering into the agreement and at the time of any change to the specified value is recommended.

The grant of an option to buy shares in the company will be a disposal for capital gains tax (CGT) purposes. However, where the price to be paid is the open market value of the shares at the time of the sale/purchase it is likely that the option would have no value.

If a specified value is chosen then a value could be attributed to the option but provided the shareholder who is party to the agreement is in reasonably good health (and especially if the specified value is the open market value at the time of entering into the agreement), such value should be negligible or nil.

## Corporation tax – payments made to life assurance plans

Payments made by the company to pay for a life assurance plan on the life of a shareholder to finance a corporate share purchase will not be a deductible expense and so will be paid out of profits after corporation tax. The remuneration of the shareholding director will not have to be increased to pay for life assurance costs, as no personal expenditure is incurred using the corporate route. The payments made to the plan will also not constitute benefits in kind as the plan will be for the benefit of the company rather than the director/shareholder.



## Taxation of proceeds in the hands of the company

The taxation of plan proceeds in the hands of the company will depend on the type of plan. As the payments made to pay for the plan will not be tax deductible, the proceeds should not be treated as a trading receipt in the hands of the company. However, each case should be discussed with the company's Local Inspector of Taxes

### Income tax

The existence of any option agreement does not affect the income tax position of the shareholder.

## What are the tax implications of the actual share purchase?

When the company makes a payment in return for the shares, there are two possibilities: the payment may be treated as a capital payment subject to potential capital gains tax in the hands of the vendor; or as a distribution subject to income tax. Given that the sale will follow the death of the shareholder and the shares will be revalued on death for CGT purposes (meaning that little or no gain would arise on a sale made relatively soon after death), clearly the preferable option is the capital treatment.

Legislation specifies conditions that need to be satisfied for capital treatment to apply.

Different provisions apply in two circumstances; firstly, in what is called a "general transaction" – where the purchase is for the benefit of the company's trade – and, secondly, where the sale is "necessary to meet an inheritance tax liability" on the shareholder's death. In addition, the following conditions are common to both sets of circumstances:-

- The company must be unquoted. (including companies whose shares are dealt in on the Alternative Investment Market (AIM)).
- The company must be a trading company (not an investment company).

The additional conditions to be satisfied for general transactions are, broadly speaking:-

- The purchase is made wholly or mainly for the purpose of benefiting the trade carried on by the company.
- The transaction should not be part of a scheme or arrangement made to avoid tax.
- The vendor must be resident and ordinarily resident in the UK.
- The vendor should have been the beneficial owner of the shares for at least five years immediately preceding the sale (reduced to 3 years if the shares are inherited).
- The vendor's shareholding must be substantially reduced, ie. by more than 25%, and after the sale the vendor must not be connected with the company.

Where the proceeds of the purchase are required to meet an inheritance tax liability on death, the conditions are as follows:-

- The company must be an unquoted trading company,
- The whole, or substantially the whole, of the payment received by the personal representatives must be used to satisfy the inheritance tax payable on death.
- Capital treatment on the sale will be allowed to the extent that the inheritance tax liability could not be satisfied without undue hardship.

If the above conditions are not satisfied the distribution treatment will apply which means the proceeds of the sale will be subject to income tax.

It is reiterated that at the time of the share purchase professional advice will be essential to ensure that the desired consequences are achieved, both in respect of the procedural requirements and the tax treatment.

For greater detail on the tax and legal aspects of the double option agreement and its effects you should consult with your financial adviser and or your legal representative.

# Draft Double Option Agreement for company share purchase following the death of a shareholder

- For the approval of legal advisers

Provided this draft agreement has been reviewed and approved by your legal adviser, please complete it using BLOCK CAPITALS

THIS AGREEMENT is made the			day of	in the year		
<b>Between</b>						
Title		Surname		of	Address	
Full forenames						
					Postcode	
("the Shareholder")						
<b>and</b> (Please insert name of company)						
Name of Company						
Whose registered office is situated at:						
Postcode						
("the Company")						
<b>The Shareholder and the Company are hereinafter collectively called "the Parties"</b>						

In this Agreement unless the context does not permit the singular shall include the plural and the masculine shall include the feminine and vice versa.

**WHEREAS**

- A. The Shareholder is the holder of shares in the Company (hereinafter referred to as 'the Shares').
- B. The Parties desire to make provision for the sale and purchase of the Shares in the event of the shareholder's death by creating options for the sale and purchase of such Shares.

**NOW IT IS HEREBY AGREED as follows:**

**1. Option to sell**

In the event of the death of the Shareholder his personal representatives shall have the option to sell the deceased's Shares to the Company such option to be exercised by notice in writing served within six months from the date of death or within one month after a grant of representation in respect of the estate of the deceased has been obtained if later or such later time as the Parties shall, by mutual agreement, determine and on the exercise of such option the Company shall purchase the Shares from the deceased Shareholder's personal representatives.

**2. Option to buy**

In consideration of the grant of the option in Clause 1 above on the death of the Shareholder the Company shall have the option to purchase the deceased Shareholder's Shares from his personal representatives such option to be exercised in writing served upon the deceased's personal representatives within three months from the date of death or within one month after a grant of representation in respect of the estate of the deceased has been obtained if later or such later time as the Parties shall, by mutual agreement, determine and on the exercise of such option the deceased's personal representatives shall sell the Shares to the Company.

**3. Price to be paid**

The value of the Shares to be sold and the Shares to be purchased shall be

(i) if the purchase takes place within

of this Agreement and a Specified Value is stated in the Schedule to this Agreement the said Specified Value

(ii) if the original Specified Value stated in the Schedule to this Agreement (or any subsequent Specified Value agreed in accordance with this sub-clause 3(ii)) has been replaced by a new Specified Value by the Parties hereto executing a Memorandum to that effect that new Specified Value. Provided however that any such new Specified Value shall only remain effective for the purpose of this agreement for a period of

from the date of execution of the Memorandum bringing it into effect unless the Parties hereto agree a different period and reflect this in the said Memorandum

(iii) in all other cases the fair market value of the Shares at the time of their sale/purchase under the terms of this Agreement as determined by an independent auditor or professional valuer appointed by agreement between the Parties including the personal representatives of the deceased Shareholder. Provided that if the Parties fail to appoint such an auditor or valuer within one month of the event giving rise to an option under Clause 1 or 2 of this Agreement then either Party may request the President for the time being of the Institute of Chartered Accountants in England and Wales to appoint an independent valuer for that purpose.

**4. Insurance plan**

The Company has effected or shall effect and maintain a life assurance plan ('the Plan') providing for the payment of such sum on the Shareholder's death as shall be mutually agreed between the Parties provided that such a Plan shall be issued to the Company and for the Company's benefit.

### 5. Life cover less/greater than agreed value

If on the death of the Shareholder the option under Clause 1 or 2 above is exercised and for any reason the life cover payable under the Plan is

- (i) less than the Specified Value or fair market value (as appropriate) of the Shareholder's Shares the balance of the said value shall be paid in

Please enter number and frequency of instalments.

Number:

Frequency:

equal instalments and the outstanding amount from time to time shall:\*

☐ bear interest at %

or

☐ not bear interest\*

\*Enter 'x' in appropriate box and enter interest rate if appropriate.

- (ii) more than the Specified Value or fair market value (as appropriate) of the Shareholder's Shares the Company shall retain the said excess without any obligation to the Shareholder's personal representatives or his family

### 6. Effect of agreement

This Agreement :

- (a) shall bind the Company and the personal representatives of the Shareholder
- (b) is conditional on the Parties satisfying all Company law requirements that permit a company to legally purchase its own shares.

In witness whereof the Parties hereto have set their hands the day and year first shown above.

All Parties should sign the agreement and have their signatures witnessed

**Signed by the said**

Signature of the Shareholder

Full Name (in BLOCK CAPITALS) of the Shareholder

**In the presence of:**

Signature of witness

Full Name (in BLOCK CAPITALS) of the Witness

Address of witness  
Postcode

**Signed by the said**

Signature of the Company Officer

Full Name (in BLOCK CAPITALS)

**On behalf of the Company in the presence of:**

Signature of witness

Full Name (in BLOCK CAPITALS)

Address of witness  
Postcode

**Signed by the said**

Signature of the Company Officer

Full Name (in BLOCK CAPITALS)

**On behalf of the Company in the presence of:**

Signature of witness

Full Name (in BLOCK CAPITALS)

Address of witness  
Postcode

# Schedule

Specified value

<b>Shareholder's name (Full name in BLOCK CAPITALS)</b>
Specified Value:

Please contact us or your adviser if you would like this  
in large print, Braille or on audio tape