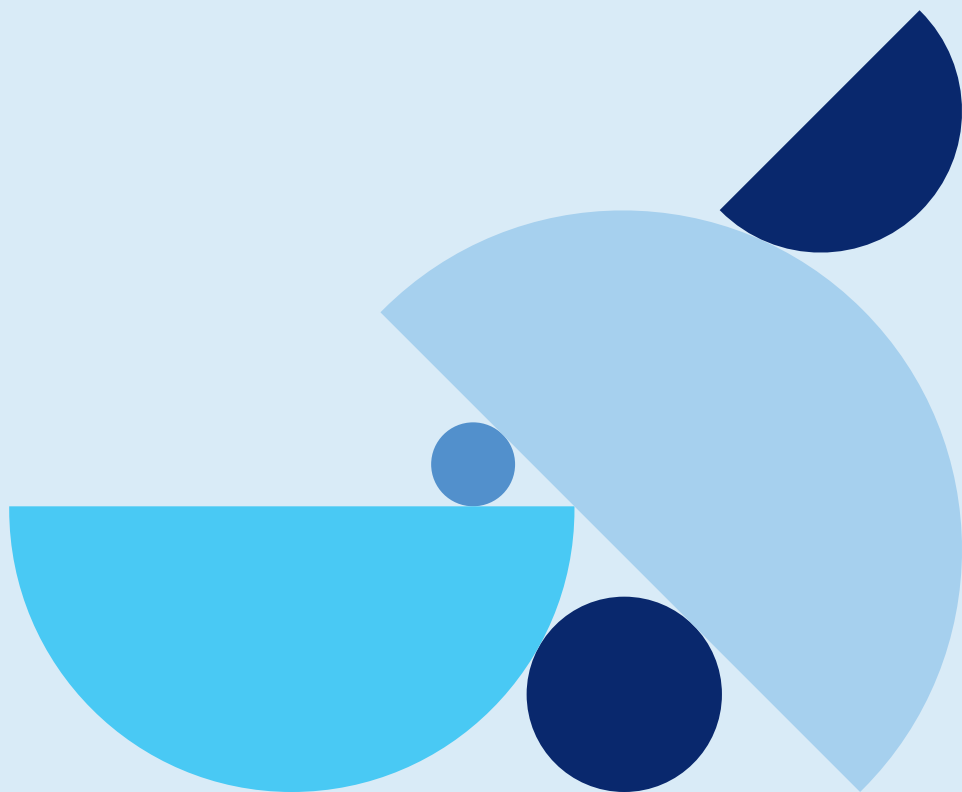


Draft Option Agreement for company share purchase following the critical illness of a shareholder



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 dealing with the 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 want to happen when a co-owner becomes critically ill or disabled.

Important note

This draft agreement is based on our understanding of current law and HM Revenue and Customs' practice (August 2018). Although every care has been taken in the preparation of the draft agreement, neither Zurich Assurance Ltd nor 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 become seriously ill or otherwise incapacitated, the shareholder will have the option to sell his shares back to the company. There is a choice between a "single option" and a "double option". Under the double option alternative the company would also have the option to buy the critically ill shareholder's shares in the company. If the double option route is chosen the company (via its directors) could force the share purchase even if the incapacitated shareholder did not wish to exercise his option to sell.

Please refer to the Frequently asked questions below for more detail about these alternatives.

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

It is possible for a limited company to purchase its shares from its shareholders, 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 sale and purchase and effecting life and critical illness plans subject to business trusts.

With a company share purchase, the company itself will effect a life and critical illness 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 an incapacitated 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 for each shareholder.

The overall effect of the arrangement is to ensure that the incapacitated shareholder, who most likely will be retiring from the business as a result of his incapacity, can receive cash in exchange for his shares in the company and the company can, as a result, remain wholly owned by the continuing 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 contemplated by the company's Articles and is possible under company law.

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

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 plans which do not provide critical illness cover.

How is an 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
- The full name and address of the shareholder needs to be inserted
- The name and registered address of the Company needs to be inserted
- In 'B' the type of option ((i) 'single' or (ii) 'double') should be selected. See notes above.

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 below.

On page 2 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 3 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 3 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 is the difference between a single option and a double option?

Single option

If a single option basis is chosen, only the shareholder who has suffered the critical illness can decide whether or not the sale of their shares to the company is to take place.

If the shares are to be sold, the company will use the proceeds of the plan (on the life of the critically ill shareholder) to buy that person's shares in the company. If the shareholder decides against sale at that time, then the cash proceeds from the critical illness plan will remain in the company, where they can be used at a later time, e.g. on the subsequent death of the critically ill shareholder, to buy out his or her shares then.

Double option

Under a double option agreement, if either the shareholder suffering the critical illness or the company (ie. effectively the other directors) decide that the sale and purchase should proceed, then all parties are bound by the agreement and the sale/purchase must take place.

When deciding whether to choose a single option or a double option, the business owners need to decide who, in effect, should be in the driving seat at the relevant time. Some may feel that it is fairer to leave the decision up to the critically ill shareholder alone; others may feel that it would be more appropriate to grant options to sell and purchase to the critically ill shareholder and the company respectively.

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

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

- The company's Articles should not restrict or prohibit a purchase of its 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.

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

Additional safeguards are required where the purchase is to be made out of capital.

What are the additional requirements if the purchase is 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 and a contract.
- Publicity: ie. a notice in the London Gazette and a newspaper circulating throughout the part of the UK in which the company is registered.

Where will the funds come from to enable the company to purchase the shares?

It is expected that the company will effect a critical illness cover plan on the life of the shareholder. The company must have the power to effect any life plans and an insurable interest in the person on whose life the plan is effected.

Can it be guaranteed that the company will be able to use the proceeds of the plan to buy the shares of the incapacitated shareholder even if the company passes a required resolution?

No. As indicated above, there is a requirement to publicise the intended purchase. Clearly, where a company has substantial debts, its 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.

There is also the stated need for the Directors to provide a solvency statement based on the facts at the time and backed up by an auditor's report. Therefore there can be no absolute guarantee that a company share purchase will be possible. This must be carefully borne in mind before this route for share purchase provision is adopted.

Are there any special requirements concerning the actual purchase?

Yes. There are time limits on when 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 are taxed as a capital receipt be classified as distributable profits?

Although a life plan (including critical illness cover) and its proceeds are 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 dies?

This draft option agreement does not cover this eventuality.

Zurich provides a separate and additional draft agreement (Draft Double Option Agreement for company share purchase following the death of a shareholder) to cover situations where business owners die.

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 a new shareholder joins the business?

If it is intended that his shares are also to be purchased by the company on his critical illness, 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 agreement will no longer be relevant and the company will no longer need to maintain the plan.

What happens if, once a shareholder becomes critically ill, the other directors running the company decide that they don't want the share purchase to proceed in the way agreed?

If the critically ill shareholder exercises his option to sell, then the purchase will proceed, irrespective of the other directors' wishes, always subject to the legal requirements for the purchase (as outlined above) being satisfied.

How is the price that should be paid for the shares decided, if the shareholder becomes critically ill?

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

1. If you enter 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 you 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 becomes critically ill, 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 other shareholders will have the option to purchase the shares and the critically ill shareholder the option to sell.

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

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.

Does the company have to take out an accompanying critical illness assurance plan?

Yes. Under the option agreement the definition of "incapacity" is linked to a payment under the plan. This means that the options can only be exercised if the shareholder suffers an illness or disability which gives rise to a payment under the plan.

A critical illness cover plan is an appropriate method of ensuring that the company has the financial means to purchase the interest of the critically ill shareholder and it would not be appropriate to grant an option to sell to a shareholder without ensuring that the company has funds to carry out the transaction. One plan can provide for the benefit to be paid on death or earlier critical illness.

What happens if there is no critical illness cover plan in force when a shareholder becomes critically ill?

If a sale/purchase of the critically ill shareholder's shares is to take place, the company will have to seek other means of raising the funds to make the purchase.

What happens if the proceeds of the plan are insufficient to buy the entire shareholding of the critically ill shareholder?

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 critical illness plan exceed the value needed to purchase the shares?

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 becomes incapacitated?

It depends on the parties involved, but under the agreement the option to sell operates for 12 months from the date of payment of the benefit under the critical illness plan and the option to buy for six months. The different terms are there to support the position that the agreement is not, in effect, a binding contract for sale/purchase.

What are the tax consequences of the Draft 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.

If a sale takes place in accordance with the terms of the agreement on a commercial basis (see above), this should not give rise to any IHT consequences.

Capital Gains Tax

(i) specified value

If a value is specified in the agreement then it is important that it is based on the current open market value of the shares, 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.

(ii) grant of the option

The grant of an option to buy shares in a 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.

Corporation tax – payments made to life assurance plans

Payments made by the company to pay for a life assurance/critical illness 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 assurance costs, as no personal expenditure is incurred using the corporate route.

Taxation of proceeds in the hands of the company

Taxation of the 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 capital gains tax in the hands of the vendor (see below) ; or as a distribution subject to income tax. Given that the sale will be during the lifetime of the shareholder and with the possibility of entrepreneurs' relief being available, clearly the preferable option is for capital treatment.

Legislation dictates the conditions that need to be satisfied for the 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. For purchase on critical illness only the first will be relevant. In addition, the following conditions are also relevant:-

- The company must be unquoted (this includes 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, or treated as 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.
- The vendor's shareholding must be substantially reduced, ie. by more than 25% as a result of the sale.

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.

Capital gains tax on sale of shares

The sale of shares following a critical illness will be a disposal for CGT purposes if capital treatment of the transaction is secured – see above.

In determining whether (and, if so, to what extent) a capital gain arises on the disposal of the shares, it will usually be necessary to deduct the acquisition price from the market value of the shares.

The use of market value instead of the price specified in the agreement to assess the level of capital gain is necessary where buyer and seller are connected. Broadly speaking, shareholders are connected with their company for this purpose.

Where the business is a trading business, then in most cases entrepreneurs' relief should be available.

This means that up to £10 million of gains made cumulatively during the lifetime of the seller (but only since 6 April 2008) will be taxed at the rate of 10%. To the extent that the gain does not qualify for entrepreneurs' relief and is not within the annual exemption from CGT (£11,700 for 2018/19) a CGT rate of 10% will be applied for gains that fall within the basic rate tax band and 20% for gains that fall within the higher rate and/or additional rate tax bands.

It is reiterated that, at the time of the share purchase, professional advice will be essential to ensure that the desired consequences are secured, 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 your legal representative.

Draft Option Agreement for company share purchase following critical illness 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		
Between						
Title	Surname	of	Address			
Full forenames						
			Postcode			
("the Shareholder")						
and (Please insert name of company)						
Name of Company						
Whose registered office is situated at:						
Postcode						
("the Company")						
The Shareholder and the Company are hereinafter collectively called "the Parties"						

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 incapacity giving rise to payment of a critical illness benefit under a policy effected by the Company in conjunction with this Agreement, (hereinafter referred to as "Incapacity" and "Policy" respectively) by creating:

Enter "x" in appropriate box.

- (i) ☐ an option to the incapacitated Shareholder for the sale of such Shares

or

- (ii) ☐ 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 Incapacity of the Shareholder then the Shareholder or his legally empowered representative shall have the option to sell his Shares to the Company such option to be exercised by notice in writing served within twelve months from the date of the payment of the benefit under the Policy 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.

2. Option to buy (only if clause B(ii) above applies)

In consideration of the grant of the option in Clause 1 above, in the event of the Incapacity of the Shareholder the Company shall have the option to purchase from the Shareholder his Shares such option to be exercised in writing served within six months from the date of the payment of the benefit under the Policy or such later time as the Parties shall, by mutual agreement, determine and on the exercise of such option the Shareholder 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 legally empowered representative of the incapacitated 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 any 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 Incapacity 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. Sum payable less/greater than agreed value

If on the Incapacity of the Shareholder the option under Clause 1 or 2 above is exercised and for any reason the sum payable under the Policy 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

6. Effect of agreement

This Agreement:

- (a) shall bind the Parties
- (b) conditional on the Parties satisfying all Company law requirements that permit a company to legally purchase its own shares
- (c) takes effect only in compliance with and subject to the terms of the Memorandum and Articles of the Company which shall take precedence over the terms hereof should there be any conflict between the two.

7. No restriction on disposal

Nothing in this Agreement shall in any way whatsoever prevent or hinder the Shareholder from disposing charging encumbering or dealing in any way with his Shares during his lifetime.

IN WITNESS WHEREOF THE PARTIES HAVE EXECUTED THIS AGREEMENT THE DAY AND YEAR FIRST SHOWN ABOVE. The 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
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In the presence of:

Signature of the Witness	Full Name (in BLOCK CAPITALS) of the Witness
--------------------------	--

Address of the Witness	
Postcode	

Signed by the said

Signature of the Company Officer	Full Name (in BLOCK CAPITALS) of the Company Officer
----------------------------------	--

On behalf of the Company in the presence of:

Signature of the Witness	Full Name (in BLOCK CAPITALS) of the Witness
--------------------------	--

Address of the Witness	
Postcode	

Signed by the said

Signature of the Company Officer	Full Name (in BLOCK CAPITALS) of the Company Officer
----------------------------------	--

On behalf of the Company in the presence of:

Signature of the Witness	Full Name (in BLOCK CAPITALS) of the Witness
--------------------------	--

Address of the Witness	
Postcode	

Schedule

Specified value

Shareholder's name (Full name in BLOCK CAPITALS)
Specified Value:

Please let us know if you would like a copy of this
in large print or braille, or on audiotape or CD.

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We may record or monitor calls to improve our service.

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