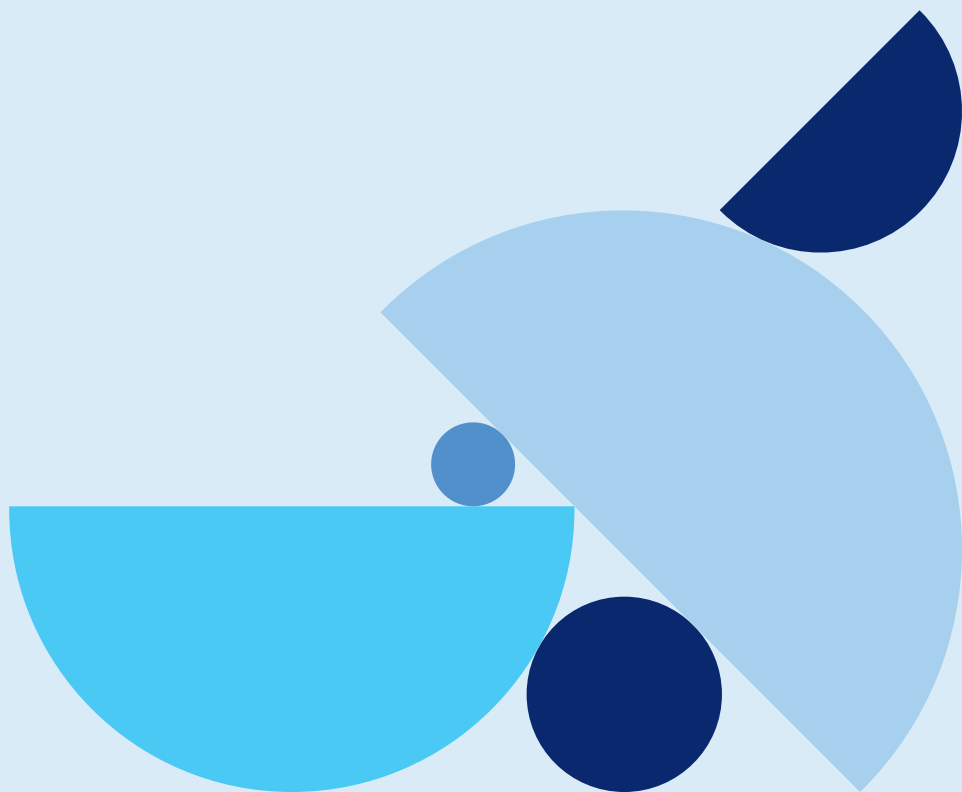


Draft Option Agreement For purchase on Critical Illness



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 partnership agreement or Articles of Association (as appropriate) about business share sale and purchase, 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 suffers a critical illness and although this agreement is subordinate to any other governing documents of the business, any conflict should be avoided.

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 for the operation of the agreement which must be referred to your own legal adviser to ensure it meets your requirements.

What is it?

It is an agreement between co-owners of a business (a partnership, a limited liability partnership ('LLP') or a limited company).

It comes into effect if one of them were to suffer a critical illness (that results in a benefit being paid under a policy which each of the co-owners would have put in force), and will enable the purchase – by the other business owners – of the critically ill business owner's interest in the business within six to twelve months of the benefits being paid under the policy.

Aims of the draft agreement

Broadly speaking, the option agreement specifies the terms on which a sale and purchase of a critically ill business owner's interest in the business can take place.

The overall effect of a business succession agreement operating on critical illness is that a critically ill business owner can receive cash in exchange for their interest in the business. The business can, as a result, remain wholly owned by the continuing business owners.

Business owners agree, when signing the agreement, whether what's known as a 'single option' or a 'double option' applies.

Single option

If a single option basis is chosen, the business owner who has suffered the critical illness can decide whether or not the sale of their business interest to their co-owners is to take place.

If the business interest is to be sold, the co-owners use the proceeds of the policy (on the life of the critically ill owner and in trust for the co-owners) to buy that person's interest in the business. If a business owner decides against sale at that time, then the cash proceeds from the critical illness policy will remain in the trust, where they can be used at a later time, or on the subsequent death of the critically ill business owner, to buy out his or her business interest.

Double option

Under a double option agreement, if either the business owner suffering a critical illness or the other business owners decide that the sale and purchase should proceed, then all parties are bound by the agreement and the sale/purchase must take place.

When should this draft agreement be used?

As already mentioned, it may be used by those with a share or shares in a partnership, LLP or a limited company.

It should, however, only be used to deal with the sale and purchase of a business interest following an owner suffering a critical illness. Zurich provides a separate draft option agreement to cover business interest sale and purchase following an owner'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 should not simply be filled in. It should be referred to your legal adviser to ensure that it is suitable in its current form.

The agreement is subordinate to the governing documents of the business, but it is still important that the two do not conflict. Professional advice is essential.

As stated above this draft agreement should not be used in conjunction with plans providing cover solely in the event of death.

How is the option agreement established?

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

If the agreement is found to be suitable for your business, the following needs to be completed, 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
- Each Party to the agreement should provide their full name and address

On Page 2 of the Draft Agreement

- The name of 'the Business' needs to be inserted in 'A'
- In 'B' the type of option ((i) 'single' or (ii) 'double') should be selected. See notes on Page 2.

On Page 3 of the Draft Agreement (section 4)

- If you wish to specify the value at which your business interest is to be purchased under the agreement you need to state (in (i) and (ii) of section 4) how long that specified value will hold good for. The minimum is one 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 4 of the Draft Agreement (section 6)

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

On Page 5 of the Draft Agreement

- Each Party should sign the agreement, and have the signature witnessed. The address of the witness also needs to be included.

On Page 6 (Schedule) of the Draft Agreement (Specified value)

- Insert the names of each Party to the agreement and the Specified Value of their Share if a Specified Value basis of valuation is to be used.

Please see 'Frequently asked questions' for more information about 'specified value' and the tax implications associated with its use.

Frequently asked questions

What happens if one of the business owners dies?

This draft option agreement does not cover this eventuality.

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

To the extent that there is more than one remaining business owner (after the death of a business owner) who are parties to the agreement covering purchase on critical illness, the terms of the agreement will continue to operate.

What happens if one of the business owners leaves the business, other than by dying or suffering a critical illness?

If any business owner ceases to be a beneficial holder of shares in or capital in the business (as appropriate), this agreement will cease to have any effect in respect of them. It would be usual to review the agreement in such a case. Where there is a critical illness plan in force, usually subject to a 'business trust', the policy will normally revert to the life assured who leaves the business.

What happens if a new business owner joins the business?

As the new business owner is not a party to the agreement, a new agreement will need to be effected.

What happens if one of the business owners disposes of, makes subject to a charge or deals in any way with his or her Share?

If there are any changes in the ownership of the Business the agreement should be reviewed and if necessary replaced with a new agreement based on the new circumstances.

What happens if one of the parties decides that they don't want the share purchase to proceed in the way agreed?

If a single option is chosen (as is usual) and the business owner who has suffered a critical illness decides that they want to exercise their option to sell their business interest, then the agreement becomes binding.

If a double option agreement is chosen, then if either the business owner who has suffered a critical illness decides to sell, or if the other business owners decide they want to buy, then the sale and purchase will proceed (in the latter case) even if it is against the critically ill business owner's wishes.

How is the price that should be paid for the interest decided if a business owner suffers a critical illness?

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

1. If the business owners enter a 'Specified Value' as part of the agreement, that value will apply for the period specified unless a new value is specified by the owners and recorded in a memorandum executed by them.
2. At any time, but not later than every one to three years (as specified), the business owners 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 or fair value are covered at the end of this section.

When a business owner suffers a critical illness, can the business, rather than the remaining co-owners, purchase the interest?

It is possible for a limited company to purchase shares, provided this is not restricted or prohibited in the Articles of Association. Once purchased, the shares are then cancelled.

A sale of shares to the issuing company will usually have some tax consequences for the business owner selling the shares. A sale (and cancellation) is generally considered more complex to implement than a sale to the continuing owner(s) in their individual capacity. In view of this complexity, it is recommended that expert advice is sought before the 'corporate route' is adopted or discarded.

Do the business owners have to take out an accompanying critical illness plan?

A critical illness plan is an appropriate method of ensuring that the other business owners have the financial means to purchase the interest of their colleague who has suffered a critical illness. Accordingly, the draft agreement anticipates that each Party has or will effect such a policy held subject to an appropriate trust. This will usually be the Zurich draft Flexible Business Trust. Under the terms of the Zurich draft 'Flexible Business Trust', in order to preserve commerciality, a business owner cannot benefit under the trust of another unless he or she has also effected a plan in trust for their co-owners.

What happens if there is no critical illness (or life assurance) plans in force when a business owner suffers a critical illness?

The surviving business owners must seek other means of raising the funds to purchase their colleague's interest if he or she suffers a critical illness.

What happens if the business owner stops making payment to the accompanying critical illness plan, or the plan lapses?

The draft agreement provides for this in Section 5 (iii). The other Parties can make good the shortfall by doing whatever is necessary, including recovery from business monies otherwise due to their colleague. It would be good practice to put in place suitable arrangements – say with the payments being paid for by the business or automatically deducted from the owners' post-tax salary or post-tax profit share – to prevent this happening.

What happens if the proceeds of the critical illness plan are insufficient to buy out completely the critically ill business owner's interest in the business?

The draft agreement makes provision for this in Section 6 by requiring that the shortfall be made up by 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 whole of the critically ill business owner's interest in the business?

The draft agreement makes provision for this. The surplus is retained by the other business owners. Again, a Specified Value and equivalent insurance can help avoid this problem.

As business owners may have different sized business interests, and as some may be older than others, the critical illness policy costs are likely to be unequal. How can this be dealt with?

It is important that the arrangement is commercial and fair between the Parties. It is thus recommended that serious consideration is given to arrangements being put in force so that the overall cost of cover is borne fairly based on who is more likely to benefit. Another option may be to share the overall cost of the arrangement in the same proportion as profits and expenses are borne.

How quickly will the purchase proceed when a business owner becomes critically ill?

It depends on the Parties involved, but under the agreement the option to sell operates for twelve months from the date of payment of the critical illness benefit. Where a double option applies, the option to buy lasts for six months.

Why is it important that any accompanying critical illness plans are written subject to a suitable trust?

Using an appropriate trust will not only ensure prompt payment of the proceeds (enabling the sale to proceed if that's what's been agreed, and releasing funds to the incapacitated business owner) but it will also ensure that the proceeds are payable to the right people (in this case the co-business owners). Zurich offer the draft Flexible Business Trust for this purpose.

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, 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 interest in the business 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.

To the extent that any proceeds of sale (after any capital gains tax – see below) remain in the estate of the selling business owner on death, then depending on that person's will provisions, the value of the rest of the estate and the chargeable transfers made in the seven years before death, some IHT may become payable.

If the business owner suffering a critical illness decides not to sell or, in the case of a double option, the remaining business owners choose not to exercise their option to buy, the trustees will retain the proceeds of the critical illness plan within the trust, and not purchase the interest in the business, typically, until their colleague dies.

The existence of an option agreement on commercial terms does not affect the IHT position of the interest in the business when a business owner dies.

Although the value of the business interest 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 and there should be no IHT on death.

The availability of business property relief 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 forgone conclusion.

The IHT position of any accompanying critical illness plan (usually written subject to an appropriate trust) is described in the notes accompanying Zurich's draft Flexible Business Trust.

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
- if one or some of the Parties to the agreement are older or other than in good health and/or the business value is strongly expected to change from that specified, then a shorter period before the Specified Value of the business interest should be reviewed (possibly 1 year) should be stated
- 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 a share in the business will be a disposal for capital gains tax (CGT) purposes. If a Specified Value is chosen then value could be attributed to the option but provided all the Parties to the agreement are in reasonably good health and roughly the same age, such value should be negligible or nil.

Where the price to be paid is the open market value of the business interest at the time of the sale/purchase it is likely that the option would have no value.

The sale of a business interest following a critical illness will be a disposal for CGT purposes.

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

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, any partners and also shareholders who together exercise control of the business will be connected for this purpose.

Where the business is a trading business, then in most cases entrepreneurs' relief should be available. This provides that up to £10million of gains made (cumulatively during the lifetime of the seller – but only since 6th April 2008) will be taxed at an effective 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 20% will be applied (10% on gains within basic rate band).

Income tax

The existence of any option agreement does not affect the income tax position of the deceased business owner who has suffered a critical illness.

The income tax considerations relating to any accompanying critical illness plan (usually written subject to an appropriate trust) are described in the notes accompanying Zurich's draft Flexible Business Trust.

Draft Option Agreement for Purchase on Critical Illness

- 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		
and						
Title		Surname	of	Address		
Full forenames						
				Postcode		
and						
Title		Surname	of	Address		
Full forenames						
				Postcode		
and						
Title		Surname	of	Address		
Full forenames						
				Postcode		
and						
Title		Surname	of	Address		
Full forenames						
				Postcode		
Hereinafter collectively called 'the Parties' and individually called 'the Party'						

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 Parties are partners in the partnership/members of the limited liability partnership (LLP) or shareholders in the company (as appropriate) known as (Please insert name of company, limited liability partnership or partnership).

Hereinafter referred to as ‘the Business’

- B. The Parties desire to make provision for the sale and purchase of any Party’s share of (Partnership), interest in (LLP) or shares in (Company) the Business (hereinafter referred to as ‘the Share’) in the event of his incapacity giving rise to payment of a critical illness benefit under a policy effected by that Party and which is held subject to a suitable trust for the primary benefit of the other Parties in conjunction with this Agreement, (hereinafter referred to as ‘Incapacity’) by creating:

Enter “x” in appropriate box.

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

or

- (ii) ☐ options for the sale and purchase of such Shares.

- C. For the purpose of this Agreement the Business shall include any successor partnership, LLP or limited company to which the entire business of the Business has been transferred and any other partnership, LLP or company specified in a memorandum signed by all the Parties.

NOW IT IS HEREBY AGREED as follows:

1. Option to sell

In the event of the Incapacity of any Party then that Party or his legally empowered representative shall have the option to sell his Share to the other Parties such option to be exercised by notice in writing served within twelve months from the date of the payment of the benefit under the said policy or such later time as the Parties shall, by mutual agreement, determine and on the exercise of such option the other Parties shall purchase the Share.

2. Option to buy*

In consideration of the grant of the option in Clause 1 above in the event of the Incapacity of any Party the other Parties shall have the option to purchase from the incapacitated Party his Share such option to be exercised in writing served within six months from the date of the payment of the benefit under the said policy or such later time as the Parties shall, by mutual agreement, determine and on the exercise of such option the incapacitated Party shall sell the Share to the other Parties.

*Only applicable if 'x' is marked in box (ii) in recital B hereof.

3. Relevant proportions

- (i) When an option in Clause 1 or Clause 2 (if applicable) is exercised, the entire Share of the incapacitated Party shall be purchased by the other Parties.
- (ii) Where there is more than one Party purchasing the Share then unless the Parties amongst themselves agree otherwise, each Party shall pay such proportion of the value agreed for the purpose of Clause 4 hereof as corresponds to the percentage of the Business's capital (LLP or partnership) or the percentage of the issued ordinary shares of the Business (company) to which that Party was beneficially entitled immediately before the event giving rise to the option in Clause 1 or 2 (if applicable) Provided Always that for the purposes of determining such a percentage it shall be assumed that the Business's capital or issued ordinary shares (as appropriate) did not include the Share to which the incapacitated Party was entitled.

4. Price to be paid

The value of the Share to be sold and the Share 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 4(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 Share at the time of its 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 any incapacitated Party. 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 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.

5. Insurance policies and trusts

- (i) Each Party has effected or shall effect and maintain a life assurance policy ("the Policy") providing for the payment of such sum on that Party's incapacity as shall be mutually agreed between the Parties provided that such a Policy shall be issued to the proposer thereof upon trust for the primary benefit of the Parties hereto other than the proposer. For the avoidance of doubt such policy could also provide for the payment of benefits on other occasions.
- (ii) Until the expiry of such a Policy or the making of a valid claim thereunder each Party shall pay all premiums and other monies payable for keeping up the Policy or such proportion of the total premiums payable in respect of all the Policies effected by the Parties as the Parties between them agree.
- (iii) In the event of any default on the part of a Party in the performance of any obligations in relation to the Policy, the other Parties may do whatever is necessary to make good such default and may recover from the Party in question all monies expended by them under this provision or may pay such monies out of the Business monies and so that any monies so paid out of the Business monies shall be charged in the books or accounts of the Business against the Party in question.

6. Sum assured less/greater than agreed value

If on the Incapacity of any Party the option under Clause 1 or Clause 2 (if applicable) above is exercised and for any reason the sum assured payable under the Policy is

- (i) less than the Specified Value or fair market value (as appropriate) of that Party's Share 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 that Party's Share the other Parties shall retain the said excess without any obligation to the incapacitated Party.

7. No restriction on disposal

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

8. Effect of agreement

This Agreement shall:

- (a) bind the Parties
- (b) cease to apply to any Party when he shall cease to be a beneficial holder of any capital or ordinary shares (as appropriate) in the Business
- (c) cease to have effect on the dissolution or winding up (as appropriate) of the Business
- (d) take effect only in compliance with and subject to the terms of the governing documents of the Business (i.e. Agreement, Members' Agreement or Memorandum and Articles as appropriate) which shall take precedence over the terms hereof should there be any conflict between the two.

IN WITNESS WHEREOF THE PARTIES 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 Party

Full Name (in BLOCK CAPITALS) of the Party

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 Party

Full Name (in BLOCK CAPITALS) of the Party

In the presence of:

Signature of the Witness

Full Name (in BLOCK CAPITALS) of the Witness

Address of the Witness

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Postcode

Signed by the said

Signature of the Party

Full Name (in BLOCK CAPITALS) of the Party

In the presence of:

Signature of the Witness

Full Name (in BLOCK CAPITALS) of the Witness

Address of the Witness

Postcode

Schedule

Specified value

Party’s name (Full name in BLOCK CAPITALS)

Specified Value:

Party’s name (Full name in BLOCK CAPITALS)

Specified Value:

Party’s name (Full name in BLOCK CAPITALS)

Specified Value:

Party’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.

PW721416002 (10/21) CMS

