

# Business Protection

## Guide to Corporate Share Purchase

For intermediary use only – not for use with your clients

This technical guide details how corporate share purchase works, what situations it may be used in as well as suitable solutions, and the impact and tax treatment of applying them.

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Zurich's document 'Business Protection – Guide To Business Succession For Companies' sets out one method of business succession share purchase, where shareholding directors effect life assurance plans in trust, written for the benefit of co-shareholders. At the same time an agreement is established, which gives options to sell and buy shares in the company on death (or on critical illness) to the critically ill shareholder or his executors on the one hand and the continuing shareholders on the other. We refer to this as the 'individual route.'

In this guide, we examine an alternative method of business succession where the company – as opposed to the individuals – buy the shares using capital in the business, or perhaps borrowing. We call this the 'corporate route.'

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# 1 The Need

The need is comprehensively outlined in the 'Business Protection – Guide To Business Succession For Companies' – which should be read in conjunction with this guide. The need is identical whether the individual or corporate route is followed.

The basic need can be summarised as follows:

The non-affected shareholding directors' need is to maintain control of the company following the death or critical illness of one of the other shareholders. On the other hand, the critically ill shareholder or the family of a deceased shareholder will usually be looking for adequate financial compensation if they are no longer going to have an interest in the business.

# 2 The Solution

## Introduction

The solution, at a high level, is identical to that set out in the Guide To Business Succession For Companies, what is needed is:

- For the shareholders to come to an agreement at an early stage as to how the shares will be dealt with on death (and/or critical illness), so that there is a ready and willing buyer of the shares – and then go on to document that agreement.
- Forward planning, so that the necessary funds are available when a shareholder dies/becomes critically ill, in the right hands and in a tax efficient manner.

The individual route sees the shareholding directors generate the financial means to buy the shares (as individuals) by making payments to a life assurance and/or critical illness policy, using the sum assured from the policy when their colleague dies or suffers a critical illness. In this guide we look instead at the company buying the shares, and not individual directors.

The main reason for considering the corporate route, of funding the necessary policies and then making the desired purchase, will usually be to minimise cost. Given that payments paid will not be deductible, whoever pays them, and that the source of the funds for payment will be the company, it will usually be cheaper for the cost to be met by the company out of 'after-Corporation Tax' money rather than out of after-income/national insurance (NIC) money. The latter would be the case under the individual route unless the payments were made from amounts owed to the shareholders by the company–loan accounts.

### What are the similarities between individual and corporate share purchase?

- Both routes involve the shares leaving the deceased's estate (or in the case of critical illness, from the shareholder) in exchange for a cash lump sum from the other co-owners or the company.
- All the problems in attaching a value to the shares are identical whatever route is chosen.
- Life assurance will usually be an economic and tax effective solution for both routes.
- An appropriate agreement will be advisable for both routes.

### What are the differences between individual and corporate share purchase?

- Through the individual route the shares are sold by the deceased's personal representatives (or by the shareholder in the case of critical illness) to co-shareholders, increasing the number of shares that the 'buying' shareholders hold. Using the corporate route sees the company buy the shares, which results in their cancellation. When shares are cancelled the number of issued shares falls and the size of the shareholding and the value of the shares of the remaining directors increase proportionately.
- There is no scope, as there is with the individual route, to vary the ratio of individual shares held.

- By using the corporate route, there is no chance that the remaining shareholders will have an 'unwelcome shareholder', which could happen in the absence of any agreement for purchase under the individual route.
- With the individual route, cash can be provided by the cover from life assurance policies from which the remaining shareholders benefit. With the corporate route, life assurance is still a key means of providing cash at the right time. The policy to provide the funds would usually be held by the company as a capital asset and reflected in the balance sheet. Funding for a share purchase through the corporate route will usually be cheaper than the individual route net of tax.
- The corporate route means that the need for a trust can be avoided.
- The corporate route requires less documentation initially, but greater work before the share purchase takes place with the need to satisfy company law and tax conditions/formalities.
- Because of the need to satisfy certain conditions at the time of purchase, there is less certainty that the corporate route will deliver the required solution.
- The individual route is more complex at the outset because of the use of a trust but is fairly simple when it comes to the actual purchase. The corporate route is easy to set up but relatively complex when the share purchase is to take place and therefore needs expert and professional advice.

### Is the corporate route possible? A preliminary assessment

If ALL the questions in the table below can be answered YES, then planning for the company to effect a purchase of shares of the deceased or critically ill shareholder out of capital (i.e. not out of income) could be considered.

- |   |                              |                             |
|---|------------------------------|-----------------------------|
| 1. Have the shareholders owned their shares for more than three years?  | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 2. Do the company's Articles permit (i.e. not restrict /prohibit) such a purchase of own shares?<br>If not, is it feasible to amend the Articles without undue difficulty? Legal advice will be necessary to ascertain this.  | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 3. Are all shareholders UK resident?  | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 4. Will the purchase be of all or at least most of the owner's holding?   | <input type="checkbox"/> Yes | <input type="checkbox"/> No |
| 5. Is it absolutely certain that the directors would be able to give a statutory declaration (at the time of the share purchase) that the purchase could be made without any prejudice to the company's creditors so that all debtors (at the time of the proposed corporate purchase) could be paid within one year? If this certainty doesn't exist would the owners be prepared to accept the risk that such a declaration could not be given? | <input type="checkbox"/> Yes | <input type="checkbox"/> No |

If the answer to any of the above questions is 'NO', the corporate route would not be possible at present. The share purchase should be organised using the individual route.

There are other conditions which will need to be satisfied for a purchase to be allowed and which will depend on the circumstances at the time of purchase. Expert advice is essential.

### Further considerations when using the corporate purchase route.

#### Do the holdings of all the owners satisfy the conditions for Business Property Relief for Inheritance Tax?

Business Property Relief (BPR) at 100% would be available for shares in most trading companies. This means that even if share values are inflated by the receipt of the policy's sum assured this should have no Inheritance Tax (IHT) consequences. If BPR is not available the receipt of the policy's sum assured may, potentially, increase the owners IHT liability. Each case will, of course, depend on its own merits.

#### What if there is considerable disparity in the size of shareholdings?

If there is considerable disparity, shareholders must consider the impact of a company share purchase on:

**Cost** – if the company pays the life assurance payments it could mean that the majority shareholder (by a disproportionate bearing of cost through reduced profits) is effectively paying for the minority shareholder to effect the purchase.

**The remaining shares** – it must also be remembered that when a company purchase takes place the shares bought will be cancelled so that the holdings of all the remaining shareholders will increase in proportion to their existing holdings.

### How important is keeping the cost of the arrangement to a minimum level at the cost of losing some of the benefits of the arrangement?

If minimising cost is a key objective then, subject to all of the other implications of corporate share purchase not outweighing reduced cost, each owner should (after advice and consultation) consider:

- The corporate share purchase route, if the corporate tax rate is less than the owner's combined tax/NIC rate. NIC is not relevant if, under the individual route, premium payments are funded by dividends. Payments under both the corporate and individual route will be paid from post-tax income, so the lower the tax suffered the more will be available to spend on the payments to the life assurance policy.
- The individual trust route if the tax/NIC suffered on the funds available will be lower than from taxed corporate profits. In most cases this will be unlikely.

However, whilst there is a likely saving through the reduced net of tax cost of pursuing the corporate route, the greater number of formalities, and consequent greater uncertainty, can add to the cost in the longer term.

### What are the key components of the corporate solution?

#### Option agreements

As with the individual route, there should be an agreement that provides for the purchase and sale of shares in the event of the death (or critical illness) of any one of the shareholders. Full details of such agreements are laid out in Zurich's 'Business Protection – Guide To Business Succession For Companies.'

When using the corporate route the option agreement should show that the company is the purchaser, with the vendor being the deceased shareholder's personal representatives or, for a purchase following critical illness, the shareholder. However, since the necessary clearances must be obtained from HM Revenue & Customs (HMRC) before a sale takes place, and company law requirements complied with, the agreement cannot provide the same element of certainty as the agreement for sale/purchase entered between shareholding directors.

### Life assurance – Term/type/amount

- Life assurance and/or critical illness policies with no investment element or surrender value are most suitable – see 'Making the arrangement tax efficient' section of this guide.
- For protection against death or critical illness, it would be normal for the term of the policy to be the shareholder's normal (or agreed) retirement age – or any other date agreed between the shareholders.
- The sum assured should be the current value of the shares or the specified value in the agreement.
- No trust forms will be necessary. The company will effect the policy on the life (or lives) of the directors, though insurable interest must be present.

### Corporate governance

- The company must have the power to effect any protection policies and an insurable interest in the person on whose life the policy is effected.
- All the documentation, publicity and applications necessary under the Companies Act must be completed before the share purchase takes place. It will not be necessary to comply with these formalities at the time the policy is effected, but only if and when the company share purchase proceeds.
- The conditions for a qualifying corporate share purchase made out of capital require that the directors need to make a statutory declaration specifying, broadly speaking, that the company can make the purchase without prejudicing the payments due to any of their creditors. This could mean that, if the policy's sum assured is treated as capital, rather than distributable profits, then even where the funds are intended to be used for share purchase it may not be possible to use them in this way. However, with the relevant provisions of the Companies Act 2006 came into effect in October 2008, it has meant that the statutory declaration has been replaced by a directors' statement. This makes the procedure simpler but doesn't remove the need to take into account the company's liabilities.



## 3 Taxation

### Making the arrangement tax efficient

#### Life assurance payments

Payments made by the company to life assurance policies 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 directors will not have to be increased to pay for life assurance costs, as no personal expenditure is incurred using the corporate route.

Using the individual route may mean that the remuneration of shareholding directors will need to be increased to fund life assurance costs. Since payments will be made out of income after tax, by choosing the corporate route (where the shareholding directors are higher rate taxpayers), having the company effect the policy will always be cheaper for companies paying Corporation Tax at the small companies' rate. This may not, however, be the case, if a directors' income is very low, or dividends are paid.

#### Taxation of proceeds

Taxation of any cover from the policy in the hands of the company will depend on the type of policy, and in particular whether it includes an investment element. As the policy is on the life of the shareholder, payments will not be tax deductible. This means 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.

Where the policy has a surrender value the company may be taxed under the loan relationship rules. For this reason it will generally not be advisable to fund for corporate purchase during lifetime (e.g. on retirement) with a policy with an investment element.

#### Inheritance Tax

Whatever price may be specified by the option agreement, for Inheritance Tax (IHT) purposes the payment of a sum assured is a change occurring by reason of the death of the life assured. The result is that the sum assured would be an asset of the company for the purposes of share valuation on death of a shareholder (S171 IHTA 1984). At any given time the market value of the policies effected by the company would be included among its assets. However, there would be a corresponding (effective) commitment to spend the funds to buy the shares so that the impact on value should be nil or negligible. In most cases there will also be Business Property Relief on the shares thus removing all negative IHT consequences.

#### Capital Gains Tax

There should be no Capital Gains Tax implications provided that the corporate share purchase takes place within a short period following death. A purchase at any other time (i.e. during the vendor's lifetime following critical illness) could give rise to a Capital Gains Tax charge on the vendor. Entrepreneurs' relief may operate to minimise any liability.

## 4 Summary

### Individual or corporate route? A final summary

You may wish to use this 'check box' to decide whether the 'corporate route' is advisable, weighing up the arguments for and against.

	For corporate route	Against corporate route
Business Property Relief position	<input type="checkbox"/>	<input type="checkbox"/>
Cost considerations	<input type="checkbox"/>	<input type="checkbox"/>
Effect on remaining shares	<input type="checkbox"/>	<input type="checkbox"/>
Control and flexibility	<input type="checkbox"/>	<input type="checkbox"/>
Easy to do, amount of formality	<input type="checkbox"/>	<input type="checkbox"/>
Certain outcome	<input type="checkbox"/>	<input type="checkbox"/>

Corporate share purchase should only be undertaken after serious and detailed consideration with the company's professional advisers.

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