

Introduction

This Guide is specifically designed to be of interest to the shareholding directors of private limited companies and smaller public limited companies. Most small private companies have an ownership pattern not dissimilar to a partnership in that the controlling shareholding are in the hands of the executive directors who run the business. The parallel, however, ends there.

Remembering that the company is an entity in its own right, the death of a shareholder, irrespective of the proportion of shares held, makes no difference to the company itself; the problem is one faced by the surviving shareholders and the estate of the deceased shareholder.

As control of the company goes with the shareholding, the surviving directors have a vital interest in retaining control by obtaining the deceased director's share. Similarly, the widow or other beneficiary, would normally have little interest in retaining the shareholding and would normally prefer to sell to the highest bidder.

The articles of many private companies provide for the purchase of such shares by surviving shareholders, such provision being either in the form of an option or an obligation.

Whatever it is, the intention cannot be implemented unless the surviving shareholders have the cash to make the purchase. If there is no cash available, the widow or other beneficiary is left with a virtually unmarketable security since the scope for transfers of shares in a private company is very restricted.

"In the UK, at the start of 2007, there were nearly 4.7 million businesses, of which 99.3% were classified as small (0 to 49 employees), and a further 0.57% were medium-sized (50 to 249 employees). The small businesses alone accounted for 47.5% of total employment in the UK - 37.4% of total turnover.

New working patterns are constantly emerging, bringing in their wake more self employed people and small businesses. Since larger companies are more likely to have succession planning in place, it's the small companies of 49 employees or less who are most in need of protection, as these businesses are more likely to feel the loss of an individual."

From the Legal & General Business Protection Adviser Guide

For the sake of clarity, where in the rest of this Guide references are made to his and him these should be taken to include hers and her etc.

Directors' Share Protection

Life assurance on the lives of the shareholding directors could help solve this situation, for both the deceased director's widow or other family and the surviving directors.

At the death of the first shareholding director, a policy on his life written under trust, with his co-shareholding directors as beneficiaries, would provide cash to enable them to buy the deceased director's shares. The surviving shareholding directors would retain full control of the business in their own hands and the family would receive immediate cash for the shares of the deceased director.

In this way, while the business may still suffer a shock at the death of a valuable executive, both the surviving directors and the deceased director's dependents get fair treatment. The deceased director's investment in the business is protected and the surviving directors retain complete control within their intimate group and prevent any interference from outsiders.

Directors' Share Protection provides money so that should one director die (or become critically ill), the remaining directors in the business can afford to exercise their right to buy the deceased director's shareholding from his or her estate.

A life assurance policy is a relatively inexpensive method of providing the required funds needed to finance the purchase of a deceased director's shareholding.

Assuming an appropriate legal agreement is in place, this will assist the remaining directors in retaining control of their business. Also an agreed price is received by the deceased director's family (or the critically ill director).

The Arrangement

Each director takes out a life policy (or life and critical illness policy) written in trust for the other directors. On the death of a director, the surviving directors then have the money to buy the shares from his estate.

The director will generally pay the premiums for the policy on his own life. The company can pay the premiums on behalf of a director, although these will then be treated as a benefit in kind and the director will become assessable for income tax on them.

The premiums can, however, be apportioned according to each director's shareholding (premium equalisation).

Valuing the Shares

An important aspect of this is to establish a fair value for the shares. Any one of several bases may be used:

- The price the shares would fetch if offered on the open market, ie a sale at 'arms length' as determined by an independent auditor. However, this implies getting a current valuation on a director's death and the life assurance cover that is in force may not be adequate.
- A valuation may be agreed between the directors themselves, based not on actual valuation but on what they feel is a fair market price at which to buy and sell. It may be the kind of business which produces a high income in comparison with the actual worth of the assets.

Many companies therefore elect for a fixed value for the purpose of the Cross Option Agreement, providing that death occurs within three years of the most recently agreed value. If this is not the case a 'fair value' will be paid as determined by an independent auditor. The arrangement should therefore be reviewed every three years.

- The net worth of the company on the basis of its last annual report, such valuation to be amended each year.
- It may be felt that at the death of the first director the income of the company might drop and as it would be less profitable for the surviving directors a smaller valuation would be in order.

In any event, the directors in discussion with the company's accountants, should endeavour to have an initial value set on which the recommendations for life assurance can be based.

Can the Company Buy Back the Shares?

Companies are allowed to purchase their own shares and the rules vary according to whether the company is quoted on the stock exchange or if it is an unquoted company. The information in this guide has been produced for unquoted companies.

Most existing companies would need to amend their Articles so that they permit the company to purchase their own shares. Having bought back its shares the company must then cancel them, creating 'unissued share capital' and thereby increasing the value of the issued shares.

It is possible, therefore, for the company to apply for life assurance cover on each director and then to buy back the shares of a deceased director.

Whilst this is certainly an option which some companies may wish to pursue, there is far more paperwork involved than under the shareholder purchase method, and some of it is likely to involve legal fees.

There is also doubt over the tax treatment of the benefits under the company buy-back method, which the company will have to get confirmed in discussion with the Inspector of Taxes.

An Overview

- **The Purpose:** To provide a sum of money to the remaining directors to enable them to buy the shares from the deceased director's estate, thereby maintaining control of the business.
- **The Amount of Cover:** The perceived value of the director's shares.
- **The Arrangement:** Life policy (own life) in trust for the benefit of the remaining directors. With a Cross Option Agreement.
- **Who Pays?** Either each director pays his own premiums (with premium equalisation being an option) or the company can pay the premiums. If the company pays the premiums they will be treated as a benefit in kind, that is, the shareholding directors will be assessed to both income tax and national insurance (NI) on the premiums.
- **Tax Treatment of Premiums.** Premiums do not attract tax relief.
- **Tax Treatment of Claims.** Proceeds are not normally taxed. This information is based on our understanding of current tax laws and HM Revenue & Customs practice, which is subject to change.

The Cross Option Agreement

A share protection arrangement is required to enable directors to purchase the shares from the deceased director's estate and to provide the deceased director's dependants with a willing buyer and cash instead of shares.

Without such an agreement, upon the death of a director, the surviving directors run the risk of the shares passing to someone with no interest in the company, or even to another company that might then be in a position to make a takeover bid.

Unless the deceased director owned a majority of the shares, the beneficiaries will probably find ownership of the shares bestows very little benefit.

Sales of shareholdings to outsiders may be restricted and a sale to the continuing shareholders may only be possible if funding has been arranged in advance. This could mean that the family of the deceased director may not receive the best price for their shareholding or indeed not find a buyer at all.

Most surviving directors in this situation will want to buy the deceased director's shares and keep control of the company, but only a few will have the right amount of cash available at the right time.

Some businesses may turn to their bankers, but many have existing loans that would rule out further advances. Also a crisis, such as the death of a director, tends to create uncertainty and instability within a company, so banks will be less likely to be willing to make a loan. A serious illness would have a similar impact.

A written agreement, known as a Cross Option Agreement is a reciprocal arrangement that ensures that the surviving directors are able to keep control of the business, by giving them the right to buy the shares of any director who dies. Such agreements also outline how the shares are to be valued.

On the death of a director, his personal representatives have the option to sell their shares in the company to the surviving directors.

Equally, the surviving directors have the option to buy the deceased director's shares from the personal representatives.

If an option is exercised by either party then the other party would be bound to buy or sell, as the case may be. This is referred to as a 'double option' agreement.

It is possible to have a 'single option' agreement under which only one of the parties to the agreement has the right to exercise an option but these are generally reserved to cover the critical illness of a director rather than his death. A director may, for example, not want to be forced to sell his shares if he has a heart attack as he may prefer to wait until he sees if he is going to be able to return to work in due course.

Typically, the directors can exercise their option to buy the shares at any time within three months of the date of death. The personal representatives can exercise their option to sell the shares at any time within six months of the date of death.

The cross option agreement is not a binding contract for sale and therefore this method preserves 100% Business Property Relief for Inheritance Tax. This may not be important if the shares are to pass on death to the spouse but this may not be the case (for example the spouse may have pre-deceased the director).

New or Former Directors

Each new shareholding director will be required to set up his own life assurance policy under the trust. The procedure will depend on how the original trust was set up.

Either the trust will automatically pay out to all the surviving directors in the company in shares equivalent to their shareholdings, or the trustees will need to exercise their power of appointment in order for the new director to benefit.

When a director leaves the company the agreement will usually cease to apply to that director and the policy will normally be allowed to lapse.

In the past, trusts have allowed directors in such cases to take over the life policy for their own benefit. However, the settlor is now normally excluded as a potential beneficiary to avoid the risk of any liability to income tax on the trust under the pre-owned assets tax.

Type of Policy

The two most common forms of life assurance used in this situation are whole of life and term insurance.

➤ **Whole of Life.** As its name implies, this type of policy is designed to provide cover for the rest of a person's life, or until they no longer require cover. If it is not known when a director will retire, a whole of life policy may be appropriate. This can be very advantageous if one or more directors subsequently has serious health issues and may be otherwise unable otherwise to obtain life assurance cover.

The disadvantage of most modern whole of life policies is that they have an investment element which makes the premiums more expensive than those for term insurance. The premiums are also usually only guaranteed for ten years (or sometimes 5 years) initially, and may be increased substantially when they are reviewed. Once the initial guaranteed period has ended the premiums are likely to be reviewed every five years and in some cases annually. This can bring a lot of uncertainty to the process.

➤ **Term Insurance.** As its name implies, this type of policy is designed to provide cover for a specified term only. The advantages that this provides over most Whole of Life policies are lower premiums and certainty of premiums for a fixed period.

As most directors hope to sell their shares and retire from active involvement in their companies at some point, a term insurance policy which covers the period up until their likely retirement can be the simplest and lowest cost solution. For this reason term insurance is usually the preferred option for most Directors' Share Protection.

Premium Equalisation

Since life assurance premiums reflect the ages, sex and sums insured of each individual director, the amounts paid in premiums do not reflect the benefits each may receive in the event of a claim.

This could be achieved through apportioning the premiums according to each director's shareholding.

Let us look at an example of Directors' Share Protection providing life and critical illness cover for a company valued at £1 million.

Director	Age	Shareholding	Sum Insured	Annual Premium
Mr Green	60	40%	£400,000	5,680
Ms Brown	55	30%	£300,000	3,240
Mr White	45	20%	£200,000	1,451
Mrs Black	35	10%	£100,000	320
Total				10,691

It is usual for the surviving shareholding directors to purchase the deceased director's shares in the same proportion as their existing shareholding and that is assumed in this example. In practice the directors may want to arrange for a deceased director's shares to be distributed on a different basis and that obviously needs settling before any life assurance cover can be arranged.

Mr Green owns 40% of the shares in the business. On Mr Green's death, Ms Brown will receive 30/60ths, Mr White will receive 20/60ths and Mrs Black will receive 10/60ths of Mr Green's share in the business.

This can be summarised as follows:

Director	Mr Green	Ms Brown	Mr White	Mrs Black
Shareholding	40%	30%	20%	10%
Mr Green dies		30/60 = 50%	20/60 = 33%	10/60 = 17%
Ms Brown dies	40/70 = 57%		20/70 = 29%	10/70 = 14%
Mr White dies	40/80 = 50%	30/80 = 37%		10/80 = 13%
Mrs Black dies	40/90 = 45%	30/90 = 33%	20/90 = 22%	

Mr Green therefore pays:

57%	of	3,240	(Ms Brown's premium) =	1,847
50%	of	1,451	(Mr White's premium) =	726
45%	of	320	(Mrs Black's premium) =	144
Total				£2,717

Ms Brown therefore pays:

50%	of	5,680	(Mr Green's premium) =	2,840
37%	of	1,451	(Mr White's premium) =	537
33%	of	320	(Mrs Black's premium) =	106
Total				£3,483

Ms White therefore pays:

33%	of	5,680	(Mr Green's premium) =	1,874
37%	of	3,240	(Ms Brown's premium) =	937
22%	of	320	(Mrs Black's premium) =	70
Total				£2,881

Mrs Black therefore pays:

17%	of	5,680	(Mr Green's premium) =	966
14%	of	3,240	(Ms Brown's premium) =	454
13%	of	1,451	(Mr White's premium) =	189
Total				£1,609

Legal Advice

A number of the insurance companies which provide Directors' Share Protection cover also provide specimen Cross Option Agreements and Trust wordings.

However, the directors of a business should pass these specimen documents to their own legal advisers to see if they sit comfortably with the Memorandum and Articles of Association of the business.

Taxation of the Shareholding

Capital Gains Tax

The death of a shareholding director will not result in a disposal for capital gains tax (CGT) purposes. His estate will be deemed to have acquired the shares at the market value at the date of death.

Where the Directors' Share Protection arrangement includes critical illness cover, the sale of the shares by the retiring director will be a disposal for CGT purposes.

Inheritance Tax

Provided the shares qualify for business property relief there should be no inheritance tax payable on death. Qualification for business property relief is not affected by the use of a Cross Option Agreement, as this does not constitute a binding contract for sale at the time of death.

Where a shareholding director suffers from a critical illness and decides to retire, and the other directors purchase his shares as part of a Cross Option Agreement, the sale proceeds will no longer qualify for business property relief.

Taxation of the Life Policy Proceeds

Income Tax

Term insurance policies generally have no liability to income tax on the payment of the sum insured as they have no surrender value.

There can be a chargeable gain on Whole Life policies when the life insured dies but the calculation is outside the scope of this Guide.

Capital Gains Tax

Generally speaking a life policy has no liability to CGT unless it is no longer held by the original owner. This might be the case if a director has an existing life insurance policy which he wants to use as part of a directors' share protection arrangement.

It should be remembered that death is not a disposal for CGT purposes.

Inheritance Tax

There is a potential periodic charge on the trust at each 10th anniversary, together with exit charges. However, provided the life assured is in reasonable health at the relevant anniversary, a term insurance policy will have little value.

Where Employees are to Purchase the Shares

In some companies almost all of the shares are held by one individual. There may be no other shareholding directors who are able to enter into a Cross Option Agreement to purchase the shares from his estate in the event of that individual's death.

The shareholder may have one or more employees whom he wants to have his shares in the event of his death. To bring this about it would not normally be necessary to set up a trust, as the employee(s) would simply need to insure the life of this shareholder for an amount sufficient to buy the shares at his death.

As with the normal Directors' Share Protection arrangement, his dependants would receive the cash and the employee(s) would obtain the shares. To create insurable interest in the life of another person, the employer and the employee(s) must enter into some form of Cross Option Agreement.

Where one of the Shareholders is Uninsurable

Should one of the shareholding directors prove to be uninsurable, there is no reason why the arrangement should not continue with the other directors.

In this instance at least the interests of the insurable directors are still being protected. Should one of them die, their dependants would receive cash instead of being left in the untenable position of a minority shareholder.

Partnership Protection

This Guide is not intended to deal with the issue of a member of a partnership dying. However, those in partnership will realise that a similar dilemma exists for them on the death of one of the partners. For a partnership there are other issues such as the fact that the death of a partner will dissolve the partnership unless this eventuality is covered in the partnership agreement.

Life assurance can play an equally important role in the business planning for partners and we would be happy to discuss this with you.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. If you are in any doubt as to whether Directors' Share Protection would be suitable for your company, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

For personal advice

If you would like to discuss whether Directors' Share Protection would be suitable for your company please ask your usual Arch adviser or contact us via one of the following:

Tel: **0845 3700 661**
or **01483 204600** (if local)
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**



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