

YOUR GUIDE TO DIRECTOR'S SHARE PROTECTION.






CONTENTS

INTRODUCTION	3
YOUR GUIDE TO DIRECTOR'S SHARE PROTECTION	4
HOW DOES THE AGREEMENT OPERATE?	5
WHAT ARE THE TAXATION EFFECTS ON THE ARRANGEMENT?	7
TRUST INFORMATION	10
IMPORTANT NOTES	11



INTRODUCTION.



The purpose of this guide is to explain how our Director's share protection scheme operates.

This guide aims to answer the most common questions that you may be faced with whilst dealing with this topic. This guide refers to shareholding directors in a Private Limited Company but in fact the plan can normally extend to include other beneficial owners of ordinary shares in the company.

This guide describes our method of setting up shareholding director's share protection utilising life or life and critical illness policies placed in trust, plus a written agreement between the shareholding directors.

The documents we've referred to in this guide are for specimen purposes only and professional advice should be sought. All examples used in this guide are based on using our trust forms. There may be other documents that may be more suitable.

Descriptions of agreements and trust forms in this guide are based on specimens we've produced. However, clients should seek their own advice as to how their agreements and trust forms are drawn up and what documentation is required.

We accept no responsibility for ensuring that the trust form and cross option agreement meets the shareholding directors' requirements.

▶ YOUR GUIDE TO DIRECTOR'S SHARE PROTECTION.

WHAT IS THE AIM OF THE AGREEMENT?

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

Our shareholding director's share protection plan is designed to ensure that funds are available in the right hands to purchase a shareholding director's shares on their death. An option is also given to the deceased's personal representatives to sell the deceased's shares to the continuing shareholding directors on death.

Critical Illness Cover can also be added at an extra cost, the agreement gives a shareholding director the option to sell their shares if they are diagnosed with one of the critical illnesses we cover.

In order for the agreement to be implemented each shareholding director must effect and maintain a life or life and critical illness policy which is written in trust for the other shareholding directors. An agreement, typically a cross option agreement, provides the basis for the share purchase and details how the purchase can be made.

The agreement should be entered into, with one agreement covering all the shareholding directors. The completed trust document will be returned by us to the trustees and should be kept with the policy(ies).

WHY IS AN AGREEMENT NEEDED?

An agreement ensures that upon the death of a shareholding director, the surviving shareholding directors can avoid 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.

On the death of a shareholding director, the Articles of Association should stipulate what happens to their shares. Usually their personal representatives and subsequently their beneficiaries will become entitled to their shareholding. Unless the deceased shareholding director owned a majority of the shares, the beneficiaries may find ownership of the shares provides very little benefit. Sales of shareholdings to outsiders may be restricted and a sale to the continuing shareholding directors may only be possible if funding has been arranged in advance. This could mean that the family of the deceased shareholding director may not receive the best price for their shareholding or possibly not find a buyer at all.

Most surviving shareholding directors in this situation will want to buy the deceased shareholding 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 shareholding 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 could have a similar impact.

HOW DOES THE AGREEMENT OPERATE?

The agreement is able to include options on death/terminal illness and, if selected, critical illness. The shareholding directors should indicate in the agreement which events they wish to plan for, which should also be reflected in the type of policies that are being arranged. The agreement operates as follows:

Death

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

The shareholding 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.

Terminal Illness Cover

A shareholding director suffering from a diagnosed terminal illness that results in a valid claim, will have the option to sell their shares to the other shareholding directors.

This option is available for six months after the date of receipt of the sum assured.

n.b. There is NOT an option for the other shareholding directors to buy the shares from the terminally ill shareholding director. A single option agreement leaves the terminally ill shareholding director in control, with the option to sell but with no corresponding option to buy given to his/her co-shareholding directors. On payment of a valid terminal illness claim no further benefits will be payable and the policy will end.

Critical Illness

A shareholding director suffering from one of the specified critical illnesses or disabilities that results in a valid claim under a life and critical illness policy, will have the option to sell their shares to the other shareholding directors.

This option is available for six months after the date of receipt of the sum assured under the life and critical illness policy, and not from the date that the critical illness is diagnosed.

n.b. There is NOT an option for the other shareholding directors to buy the shares from the critically ill shareholding director. Although this option could be attractive to the other shareholding directors, it may not be for the shareholding director who has had a heart attack and who intends to resume work, once fully recovered, after only a few months. A single option agreement leaves the critically ill shareholding director in control, with the option to sell but with no corresponding option to buy given to his/her co-shareholding directors. On payment of a valid critical illness claim no further benefits will be payable and the policy will end.

Under their agreement, each shareholding director must effect and maintain a life or life and critical illness policy under an appropriate trust, to provide the required amount of money to purchase the shareholding. The beneficiaries of the trust would be the co-shareholding directors. This ensures that the proceeds from a policy are available for them to buy the shareholding director's shares on death or diagnosis of a critical illness or terminal illness.



For further information on terminal illness, please refer to the Key Features Document.

For further information on the critical illnesses we cover please ask for a copy of our Guide to Critical Illness Cover.

WHY IS THE AGREEMENT NOT A BINDING CONTRACT FOR SALE?

Under current legislation many shares may qualify for 100% Business Property Relief for Inheritance Tax purposes. However, if the share purchase agreement in force is a binding contract for sale, such as a buy and sell agreement, Business Property Relief would be lost. This may not be important if the shares are to pass on death to the spouse (which is fully exempt from Inheritance Tax). Nevertheless, this exemption should not be relied upon as the spouse may die before the shareholding director. Consequently, if a binding agreement for sale were in place, further Inheritance Tax planning might be required.

A cross option agreement however is not a binding contract for sale and therefore this preserves Business Property Relief. This gives the surviving shareholding directors an option to buy the shareholding director's shares and the personal representatives of the deceased have a matching option to sell to the surviving shareholding directors.

WHAT PRICE IS TO BE PAID FOR THE SHARES?

It is important that when putting a cross option agreement in place, an appropriate method is agreed on as how the shares are to be valued.

Open market value of the business

This option would ensure that all parties are fairly treated. This can, however, lead to certain practical problems, such as how the business can be sure that the amount of cover in force equates to the value that would have to be paid? The reference to open-market value means that this has to be formally arrived at. This could lead to delays in the completion of the sale and purchase and often can result in the whole plan being delayed or even never finalised.

Fixed value for the shares

By adopting a fixed price method of valuation, the business adopts a method of valuing a share in a business. This method ensures that the appropriate level of life cover can be effected.

Legal & General's cross option agreement has been drafted on the basis that should death/a terminal illness (or payment under a life and critical illness policy) occur within three years of the agreement being established, a specified value (as written into the agreement) will be the price to pay for the shares. However, if death/a terminal illness (or payment under a life and critical illness policy) occurs more than three years after the date of the agreement a **'fair value'** will be paid.

Fair Value of the Shares

The fair value of the shares of each Shareholder will be the relevant proportion of the market value of the Company as at the date of the Shareholder's death or the Payment Date (as the case may be). This amount will be determined by an independent auditor or professional valuer who will be appointed by the surviving Shareholders and the personal representatives of the deceased Shareholder. If such a valuation is not carried out then the 'fair value' of the Shares shall be the relevant proportion of the said market value as determined by the President for the time being of the Institute of Chartered Accountants in England and Wales.

Such an arrangement should be reviewed at least every three years to ensure it continues to meet the business's requirements. The sum assured under the life or life and critical illness policy should also be reviewed at the same time. If this is not done the price to be paid under the agreement reverts to the 'fair value'.

Whilst Legal & General provide a cross option agreement, it is important that the shareholders get their agreement approved by their own legal advisers.

WHAT IF NEW SHAREHOLDING DIRECTORS JOIN THE BUSINESS?

All new shareholding directors should enter into the arrangement by completing a supplemental agreement. An additional life or life and critical illness policy must also be effected and the appropriate trust forms completed.

HOW LONG DOES THE AGREEMENT LAST FOR?

The agreement can last indefinitely but, as mentioned earlier, regular reviews should be carried out.

WHAT ARE THE TAXATION EFFECTS OF THE ARRANGEMENT?

INHERITANCE TAX

Providing all shareholding directors participate, there'll be no Inheritance Tax on the premiums payable as it will be considered to be a bona fide commercial arrangement. If this were not the case, life policy premiums would usually fall within one or more of the Inheritance Tax exemptions. The proceeds of the life or life and critical illness policy when written under trust will be payable to the trustees normally free from Inheritance Tax, since they don't form part of the deceased's estate. The estate of the deceased shareholder includes the shares and not cash, thus preserving Business Property Relief on the value of the shareholding.

Periodic charge

An Inheritance Tax liability may arise on each ten year anniversary of the creation of the trust. The charge is based on the value of the property in the trust, which is referred to as 'relevant property'. The value of the relevant property will be the value of the policy. The maximum rate of tax that can be charged on the relevant property is currently 6% of the assets over the nil rate band, less any chargeable transfers made by the shareholding director in the seven years preceding the creation of the trust. A periodic charge may become payable where the shareholding director dies and the value of the policy proceeds exceeds their available nil rate band.

Exit charge

An Inheritance Tax liability may arise where capital leaves the trust. For example, a charge may arise where the trustees pay the policy proceeds to a beneficiary following a claim. Different calculations are done depending on whether the distribution of capital occurs before or after the first ten year anniversary of the trust.

Where an exit occurs during the first ten years, the calculation is based on the values at the creation of the trust. Where the exit occurs between ten year anniversaries, the calculation is based on the values at the previous ten year anniversary. In either case, the rate of tax upon which the exit charge is based is a maximum of 6%.

CAPITAL GAINS TAX

There is no Capital Gains Tax on death but there could be a liability on beneficiaries of the estate on the increase in value of the shares between death and sale, although in practice this would be rare.

A Capital Gains Tax liability may arise, in the event of the sale of a shareholding director's shares due to a terminal or critical illness.

INCOME TAX

An Income Tax liability may arise from the potential reversion of the trust fund to the shareholding director if they should resign or retire from the company or otherwise cease to be a shareholding director. This is also known as Pre-Owned Asset Tax (POAT).

HOW ARE THE FUNDS TO MAKE THE PURCHASE PROVIDED?

A life or life and critical illness policy is written on the shareholding director's own life. The cross option agreement states that each shareholding director shall, no later than one month after the date of the agreement, effect either a life policy or life and critical illness policy. Each policy will be subject to a trust for the other shareholding directors so that, if there is a death or critical illness/terminal illness claim, the proceeds of the plan would be paid to the continuing shareholding directors to enable them to purchase the deceased's/critically ill/terminally ill shareholding director's shares. Examples of these forms are available from us, and details on how to complete the trust is included in this guide.

WHO SHOULD PAY THE PREMIUMS?

Each shareholding director undertakes to pay premiums on their own life. These may not necessarily be the same because of the different ages and sums assured. If possible, the company should adjust their pay or fees to compensate for this.

If the company pays the premium on behalf of the shareholding director this will be classed as remuneration and the shareholding director will become liable for income tax and National Insurance Contributions (if applicable) on it.

WHAT TYPE OF POLICY SHOULD BE EFFECTED?

This will depend upon individual circumstances and affordability. For example, if it is not known when a shareholding director will retire, a Whole of Life Protection Plan may be an appropriate policy.

If Critical Illness Cover is required this can usually be arranged as an additional option to a term assurance policy.

WHAT IF A SHAREHOLDING DIRECTOR LEAVES THE BUSINESS?

If a shareholding director leaves the company the agreement will normally cease to apply to that shareholding director.

The policy will automatically revert to the shareholding director.

WHAT IF THE SUM ASSURED DOESN'T MATCH THE PRICE TO BE PAID FOR THE SHARES AS SPECIFIED IN THE AGREEMENT?

If the agreement is reviewed and updated regularly, it's unlikely that the proceeds of the life policies will differ significantly from the price to be paid for the shares. However, of course, if the specified sum isn't reviewed and the agreement not amended, then the price to be paid under the agreement reverts to the **open market value**. This is the traditional method of share valuation, and this could mean that the sums assured under the policies may not match the price to be paid. The agreement should therefore be frequently reviewed.

If the sum assured is less than the agreed value, the agreement gives the option for the balance to be paid to the shareholder's personal representatives in instalments over an agreed period. The agreement allows specific details to be inserted regarding the number and frequency of payments. This amount may or may not bear interest and the appropriate wording should be deleted.

If however, the sum assured exceeds the agreed value, the co-shareholding directors can, if they wish, pass the excess to the shareholder's personal representatives or keep it themselves. The agreement caters for either arrangement and if this form is used then the appropriate wording should be inserted.

WHAT IF THE SHAREHOLDING DIRECTORS DON'T WISH TO SPECIFY A VALUE FOR THE SHARES TO BE PURCHASED?

Shareholding directors should be encouraged to specify a value. If they don't, then an amendment to the agreement will be needed in order to revert to the ordinary open market value at the time the purchase is made.

WILL THE AGREEMENT PREVENT A SHAREHOLDING DIRECTOR FROM SELLING ANY OF THEIR SHARES DURING THEIR LIFETIME?

The Articles of Association should govern this but the provisions detailed in the sample agreement will not prevent any sale or other disposal of the shareholding director's shares during his lifetime. The agreement only covers share transfer on death, terminal or critical illness (if selected) of the shareholder.

WHAT IF THERE'S ALREADY A SHARE PURCHASE AGREEMENT IN FORCE?

It is important that this is reviewed. We provide an agreement for the consideration of the client's legal advisers, should they wish to change it. The company's legal advisers should ensure there is no conflict between any existing agreement and the wording of the cross option agreement.

▶ OTHER SHARE PROTECTION ARRANGEMENTS.

There are also other methods of share protection (for example, buy and sell) and other ways of writing the life policy (for example, life of another, Absolute trust, joint life first death).

THE BUY AND SELL AGREEMENT

The shareholding directors enter into an agreement whereby on retirement or death, the retiring shareholding director or their estate will sell their share to the remaining shareholding directors who, in turn, will buy. The shareholding directors will purchase the shares in the proportion in which the remaining shareholding is held. There may be disadvantages in using the buy and sell method such as the loss of Business Property Relief, so if a shareholding director dies, their shares may be liable to Inheritance Tax.

COMPANY BUY BACK

The shareholding directors enter into an agreement whereby the Company buys the shares on the retirement or death of the shareholder. The company then cancels the shares. The authorised share capital is reduced accordingly by the nominal value of the shares cancelled. There are a number of legal requirements for the buy back to take place.

LIFE OF ANOTHER

As a way of writing the life policy, has its limitations in that it's inflexible when the business dissolves or when new shareholding directors join. In addition, if there are more than two participants each has to have a policy on the lives of all the other shareholding directors, resulting in a large number of policies.

If there are only two participants a joint life policy can be written.

i

Note: Similar share protection schemes can be arranged for partners in a Partnership and members of a Limited Liability Partnership. See our technical guides entitled 'Your Guide to Partnership Protection' and 'Your Guide to Limited Liability Partnership Share Protection'. We also offer Key Person protection. See our technical guide entitled 'Your Guide to Key Person Protection'.

TRUST INFORMATION.

WHY USE A TRUST?

A trust is a way of transferring the policy (the asset) to the other shareholding directors (the beneficiaries) without giving them full access to and control over it. The trust will specify who the shareholding director wants to look after and control the asset (the trustees).

WHO ARE THE BENEFICIARIES?

The beneficiaries are the other shareholding directors of the Company.

WHAT IS A TRUSTEE?

A trustee is someone the shareholding director appoints to look after the asset(s) they are putting in trust (for example, their Legal & General business protection policy). The trustees are the legal owners of the trust assets. They must keep to the conditions of the trust, and act for the benefit of the beneficiaries of the trust. When the trust asset is a life assurance policy, in the event of the shareholding director's death, the trustees will need to make a claim for the proceeds and ensure that these proceeds are passed to (or used for) the beneficiaries of the trust.

WHO CAN BE APPOINTED AS A TRUSTEE?

Normally the company secretary and/or other shareholding directors would be appointed as trustees. It is also a good idea for them to be resident in the United Kingdom. Solicitors and accountants can act as trustees but they will charge for their services.

CAN THE SHAREHOLDING DIRECTOR BE A TRUSTEE?

Yes. The shareholding directors' share protection trust automatically makes the shareholding director a trustee.

CAN THE SHAREHOLDING DIRECTOR APPOINT ADDITIONAL TRUSTEES IN THE FUTURE?

Yes, with our directors' share protection trust the shareholding director has the power to appoint additional trustees at any time.

After they die, the trustees will have the power to appoint additional trustees.

HOW MANY TRUSTEES SHOULD THE SHAREHOLDING DIRECTOR CHOOSE?

It is a good idea to have at least two trustees at any time. For this reason, it is normally sensible to appoint at least two trustees in addition to the shareholding director.

WHAT HAPPENS IF A TRUSTEE DIES?

If a trustee dies, the remaining trustees can still carry on but a replacement could be appointed. If the trustee was the last surviving trustee, their legal personal representatives will have the power to appoint additional trustees or take over as trustees themselves.

WHAT HAPPENS IF A TRUSTEE NO LONGER WANTS TO BE A TRUSTEE?

A trustee can retire from the trust with the consent of the other trustees, provided that there are at least two trustees following the retirement.

HOW DO THE TRUSTEES MAKE A CLAIM?

In the event of your death the trustees will need to send the following items to Legal & General's Life Claims Department:

- Directors' Share trust deed (and any subsequent deeds)
- The original policy document
- An official death certificate

THE ADDRESS TO SEND THESE ITEMS TO IS:

Legal & General Life Claims Department
City Park
The Droveway
Hove, East Sussex BN3 7PY

Once the claim is accepted, the trustees will be paid by direct credit.

QUICK CHECKLIST FOR THE DIRECTORS' SHARE PROTECTION TRUST

Before sending the trust to Legal & General, have you

1. Dated the trust?
2. Completed the Settlor's details?
3. Completed the Additional Trustees details?
4. Inserted the name of the Company?
5. Completed the details of the application?
6. Crossed through mistakes (rather than using correction fluid) and have all parties initialled any changes?
7. Signed the trust and had those signatures witnessed?

IMPORTANT NOTES.

We have written this guide to give general information about placing business protection policies in trust for shareholding directors. It is not intended to replace legal advice. If this trust does not meet the shareholding directors' needs then they should talk to their legal and their financial advisers.

We have based the information in this guide on our understanding of the laws relating to trusts and Inheritance Tax at the time of publication. Although we have made every effort to make sure that the information is accurate, we cannot take legal responsibility for any particular statements.

This guide is based on our understanding of current law and HMRC practice, which can change.

In preparing this guide we have assumed that only Legal & General's Directors' Share Protection trust is to be used in conjunction with Legal & General's business protection policies. We can also provide partnership, key person and limited liability partnership share trust forms. The information in this guide does not apply to family protection. Legal & General have separate literature for family protection. Please see your financial adviser for more details.



Legal & General Assurance Society Limited

Registered in England No. 166055

Registered office: One Coleman Street, London EC2R 5AA

We are authorised and regulated by the Financial Services Authority.

W13228 10/10 NON GASD



legalandgeneral.com