

COMPANY SHARE BUY BACK GUIDE.






CONTENTS

INTRODUCTION	3
WHAT IS THE AIM OF THE AGREEMENT?	4
HOW DOES THE ARRANGEMENT WORK?	4
WHY IS AN AGREEMENT NEEDED?	4
HOW DOES THE AGREEMENT OPERATE?	5
WHAT ARE THE TAXATION EFFECTS OF THE ARRANGEMENT DESCRIBED?	7
WHAT ARE THE COMPANY LAW ISSUES WITH THE METHOD DESCRIBED?	8
CASE STUDY	11

INTRODUCTION.



The purpose of this guide is to explain in plain English how a company share buy back arrangement operates.

The guide aims to answer the most common questions that you may be faced with whilst dealing with this topic.

The guide describes a possible method of shareholder protection that involves life assurance (and where selected, critical illness policies) and a written agreement between a company and its shareholders.

The guide has been drafted on the basis that the company concerned is an unquoted, private company limited by shares and registered in England & Wales and that any share purchase is 'off-market' (as defined in section 693(2) Companies Act 2006).

The guide provides general guidance for professional advisers and does not purport to deal with all the possible questions and issues that may arise in any given situation. This information represents a guide to Legal & General's current understanding of how the law and HM Revenue & Customs' practice might apply. We do not accept responsibility for any losses arising from actions or inactions taken as a result of this information and you should always take your own advice. Please be aware that the law and HM Revenue & Customs' practice may be subject to change from time to time. Professional advice should always be sought if considering entering into a company share buy back arrangement.

▶ WHAT IS THE AIM OF THE AGREEMENT?

A company share buy back arrangement aims to provide a company with a way of buying shares from a shareholder on his or her death. Such an arrangement can provide a deceased shareholder's estate with a buyer for the shares where a

market for them might not ordinarily exist. The arrangement can also provide the company with the funds with which to purchase the shares and a legal option to do so. Similarly, provisions can be put in place for a shareholder's critical or terminal illness.

HOW DOES THE ARRANGEMENT WORK?

The arrangement consists of:

- 1 – A life assurance policy (with appropriate benefits selected) on the life of each shareholder from whom the company would wish to purchase shares. The application would be proposed by the company on the life of the shareholder. Any resulting policy would be issued to the company as grantee and policy owner.
- 2 – An option agreement entered into between the company and the shareholders. The agreement would provide legal options to the company (and possibly the shareholder or his or her estate) in the event of the death (or critical or terminal illness) of a shareholder.

WHY IS AN AGREEMENT NEEDED?

Without an agreement, upon the death of a shareholder the company and its surviving shareholders have the prospect of the deceased's shares passing to someone with no interest in the company, or even to someone with a competing interest.

The articles of association should stipulate what happens on the death of a shareholder. Usually the shareholder's personal representatives and subsequently the beneficiaries of the estate will become entitled to the shareholding.

Unless the deceased shareholder owned a majority of the shares it may be that the recipient of those shares finds that they provide 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 shareholder may not receive the best price for their shareholding or indeed not find a buyer at all.

Most surviving shareholders will want to keep control of the company. One option is for the company to buy the shares from the deceased shareholder's estate. Will, however, the company have the cash available to do this? The company may consider asking for a bank loan, however, any existing loans may rule out further advances. Also, a crisis such as the death of a shareholding director may create uncertainty and instability within the company such that banks will be less likely to be willing to make a loan. Even if the company has some money it may still not be sufficient, especially when taking into account the issues surrounding the general requirement for a company to maintain share capital.

A possible solution is forward planning through the company owning a life assurance (and Critical Illness Cover – if selected) policy on the life of each shareholder.

(Other shareholder protection methods are available. Please see our Directors' Share Protection Technical Guide W13228 for a different method of shareholder protection.)

HOW DOES THE AGREEMENT OPERATE?

The agreement is able to include options for death and, if required, critical illness. The agreement should indicate which events the parties wish to plan for and this should be reflected in the type of policies that are being arranged. An agreement may be made along the following lines:

Death

On the death of a shareholder, the company has the option to buy the shares of the deceased shareholder from the personal representatives of the deceased. If the option is exercised, the personal representatives must sell the shares. The company can exercise its option within a period specified in the agreement, for example, within three months of the date of death.

Terminal or critical illness cover

On the terminal or critical illness of a shareholder, the company has the option to buy the shares of the ill shareholder within a period specified in the agreement, for example, within three months of the receipt of the sum assured under the policy containing terminal or critical illness cover.

Often such an agreement will not include an option for the shareholder or his or her personal representatives to sell the shares to the company. The reason for this is that it may not always be

possible for the company to purchase the shares. The result will be a 'single option' agreement rather than a 'cross option' agreement. Clearly, this provides no certainty for an ill shareholder (or the personal representatives of the deceased shareholder) that he will be able to sell the shares to the company.

Under the agreement, the company can agree to effect and maintain a life assurance policy (and critical illness cover if agreed) to provide the required amount of money to purchase the shareholding.

The company will need to comply with certain company law requirements in order to repurchase the shares. Subject to this, once the shares have been repurchased they will be cancelled. The effect of this is to increase the shareholding of the remaining shareholders in proportion to their previous shareholdings. An example of this is given in the case study later.

CAN ANY BUSINESS PROPERTY RELIEF BE PRESERVED?

Under current legislation many shares will qualify for 100% Business Property Relief for Inheritance Tax.

However, if the company share buy back agreement in force were a binding contract for sale, such as a buy and sell agreement, any Business Property Relief would likely be lost. This may not be important if the shares are to pass on death to the shareholder's spouse or civil partner where an Inheritance Tax exemption applies (assuming UK domicile). Nevertheless, this exemption should not be relied upon as the spouse or civil partner may die before the shareholder. Consequently, if a binding agreement for sale were in place, further Inheritance Tax planning might be required.

A properly drafted option agreement, however, is not a binding contract for sale and therefore this method preserves Business Property Relief. This method simply gives the company an option to buy the deceased shareholder's shares.

WHAT PRICE IS TO BE PAID FOR THE SHARES?

It is important that when putting an option agreement in place an appropriate method is agreed as to how the shares are to be valued. Once in place, it is important the arrangement is reviewed regularly to check that it is still appropriate for the circumstances of the parties. This should also provide a good opportunity to review the life and critical illness (if selected) policy.

It is important to note that the proceeds of the life policy will increase the cash balance of the company and therefore the value of the shares. This needs to be factored into the amount of life cover selected.

HOW LONG CAN AN AGREEMENT LAST FOR?

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

HOW ARE THE FUNDS TO MAKE THE PURCHASE PROVIDED?

A life assurance or life assurance and critical illness policy is written on a 'life of another' basis with the company as the owner and the shareholder as the life assured. If there were a death/critical illness claim, the proceeds of the policy would be paid to the company to enable it to buy the shares.

WHO SHOULD PAY THE PREMIUMS?

It would be expected that the company would pay the premiums. The company will own the policy and as such the premiums would not constitute a taxable benefit for the life assured.

WHAT TYPE OF POLICY SHOULD BE EFFECTED?

This will depend upon individual circumstances and what can reasonably be afforded. For example, if a shareholder is a director of the business and it is not known when he or she will retire, a whole of life policy rather than a term policy could be considered.

What if the sum assured doesn't match the price to be paid for the shares as specified in the agreement?

If there are regular reviews of both the agreement and the policy it is likely that the proceeds of the life policy will match the price to be paid for the shares. An option agreement could make provision for the possibility of the sum assured being more or less than the agreed valuation of the deceased's shares.

WOULD AN AGREEMENT PREVENT A SHAREHOLDER FROM SELLING ANY OF HIS/HER SHARES DURING THEIR LIFETIME?

The articles of association should govern this. It is possible for the option agreement to allow this and it will not in any way prevent any sale of other disposal of the shareholder's shares during his lifetime.

WHAT IF THERE IS ALREADY A SHARE PURCHASE AGREEMENT IN FORCE?

It will be important to encourage the shareholders to review this agreement with their legal advisers.

▶ WHAT ARE THE TAXATION EFFECTS OF THE ARRANGEMENT DESCRIBED?

INHERITANCE TAX

Where the company is paying premiums on its policy there is no Inheritance Tax due in relation to the premiums. Since the company owns the policy, the proceeds are not in the estate of the deceased and therefore are not subject to Inheritance Tax.

The shares of the company are in the estate of the deceased; however, if those shares qualify for Business Property Relief of 100% no Inheritance Tax will be payable on them. Where Business Property Relief doesn't apply (or where only 50% relief is available) it is worth considering whether the receipt of the policy proceeds will increase the share value (and therefore any potential Inheritance Tax liability) in the estate of the deceased.

CORPORATION TAX

It is not expected that the company would receive corporation tax relief on the payment of the policy premiums.

Unless the life policy is capable of acquiring a surrender value, the 'loan relationship' rules will not apply. If death or critical illness benefits were to become payable under the policy it is not expected that those benefits would be treated as a trading receipt by the company for corporation tax purposes.

Where a life policy is capable of acquiring a surrender value, the 'loan relationship rules' will apply (except where that policy was taken out prior to 14 March 1989). (These rules are outside the scope of this guide and professional advice should be sought if required.)

CAPITAL GAINS TAX AND INCOME TAX

The starting point is that where shares are re-purchased by a company, there is a distribution by the company to the extent that the purchase price exceeds the amount originally subscribed for the shares. Generally this distribution will be subject to income tax.

Where the company concerned is an unquoted company, it may be possible for this excess to be treated as capital. Certain conditions need to be met. Broadly, the conditions for shareholders of unquoted companies are that:

- The seller of the shares must be resident and ordinarily resident in the UK
- The seller must have owned by the shares for five years
- The seller must not continue to hold shares in the company after the sale, or if he does continue to hold shares the seller's interest must have been substantially reduced
- The purchase must not be part of an arrangement of which a main purpose is to avoid tax
- The purchase must not be part of an arrangement of which a main purpose is to enable the seller to receive profits without receiving a dividend.

Where all or most of the payment from the company is used for the payment of the seller's Inheritance Tax liability as a result of death it may be possible for some of the conditions above to be waived.

It is possible to apply to HMRC in advance for confirmation that the purchase will not be treated as a distribution ('advance clearance'). HMRC clearance would need to be sought for the transaction in any event.

▶ WHAT ARE THE COMPANY LAW ISSUES WITH THE METHOD DESCRIBED?

There is a general rule against a limited company acquiring its own shares. There are, however, some exceptions to this general rule. One of these exceptions is that a private limited company may purchase its own shares provided:

- a) The relevant provisions contained within Companies Act 2006 allow it and that the subsequent procedures are followed, and
- b) The company's articles do not prevent it.

Generally, in order for a private limited company to purchase its own shares:

- There must still be issued share capital (other than redeemable shares or treasury shares) remaining after the shares have been repurchased. Thus, this method of share protection is not appropriate for a company with a single shareholder.

- The shares being purchased must be fully paid.
- The shares must be paid for on purchase.
- The contract to buy back the shares must be approved (in advance of the purchase) by a special resolution.

In addition, where a company wishes to purchase its own shares, it must first do so out of its distributable profits, or the proceeds of a fresh issue of shares made for the purpose of financing the purchase. A fresh issue of shares may not be a realistic prospect for a company if it is considering shareholder protection due to the unavailability of other willing buyers of the shares. Only once any distributable profits have been exhausted, can the company purchase its own shares from its capital.

PURCHASE OUT OF DISTRIBUTABLE PROFITS

Where a company is to purchase the shares out of distributable profits:

- The contract terms for the purchase must be approved by a special resolution before the contract is entered into. Alternatively, the contract must state that purchase cannot take place until its terms have been approved by a special resolution of the company. Since section 694(3) Companies Act 2006 includes not only contracts to purchase the shares but also contracts “under which the company may (subject to any conditions) become entitled or obliged to purchase the shares”, option agreements should be drafted carefully.
- The contract (or its terms) must be made available to the shareholders. The rules as to access depend on whether the resolution is to be made in writing or by meeting.
- The company must keep a copy of the contract available for inspection for 10 years (giving notice to Companies House).
- Certain documents must be filed with Companies House.
- Non-compliance with the requirements to file or make certain documents available for inspection is a criminal offence.

PURCHASE OUT OF CAPITAL

Where a private limited company does not have sufficient distributable profits to make a purchase of its shares it may resort to its capital (subject to any restriction there may be in the articles) to the extent that distributable profits are insufficient. In order for there to be a payment out of capital:

- The directors must make a statement in a prescribed format that addresses a number of points including such issues as the company’s ability to repay its debts and its future prospects.
- The company’s auditor must also provide a report (annexed to the directors’ statement).
- The contract terms for the purchase must be approved by a special resolution before the contract is entered into (alternatively, the contract must state that purchase cannot take place until its terms have been approved by a special resolution of the company). Since section 694(3) Companies Act 2006 includes not only contracts to purchase the shares but also contracts “under which the company may (subject to any conditions) become entitled or obliged to purchase the shares”, option agreements should be drafted carefully.
- The payment must be approved by a special resolution of the company within one week of the directors’ statement.
- If the payment is approved, this fact must be advertised in the Gazette (and an appropriate national newspaper or to each of its creditors) within one week of the special resolution authorising the payment.
- The directors’ statement and auditors report must be kept available for inspection for a specified period and specified documents must be filed at Companies House.
- Non-compliance with the requirements to file or make certain documents available for inspection is a criminal offence.



CASE STUDY

John Spencer, Stephen Young and Mark Jones are directors in Spencers Plant Hire Limited.

The current shareholdings are as follows:

Shareholder	Shares	Value	Percentage of total shares
John Spencer	40	£200,000	40%
Stephen Young	20	£100,000	20%
Mark Jones	40	£200,000	40%

The company effects a Term Assurance policy on each of John Spencer, Stephen Young and Mark Jones with a sum assured equal to the value of their shareholding.

The company and the shareholders enter into an option agreement.

If Stephen Young were to die and if the company were to purchase his shares from his personal representatives the shareholdings would be as follows (following the cancellation of the repurchased shares):

Shareholder	Shares	Percentage of total shares
John Spencer	40	50%
Mark Jones	40	50%



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