

Business Protection



Shareholder protection – an unquoted company buying its own shares

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For the purpose of this factsheet, an outgoing shareholder is a shareholder who has died or become critically ill. If a shareholder dies or becomes critically ill, the continuing shareholders will usually want to keep control of the company as they won't want the outgoing shareholder's shares passing to someone with no interest in the company, or to a third party that they can't amicably work with. The outgoing shareholder or their family might also prefer to receive a cash payment for the shares.

To make sure they can keep control of the company, the continuing shareholders might need advance funding as the company might not have enough funds available. Life protection policies can be used to help plug this cash shortfall. Rather than each shareholder taking out their own life and/or critical illness cover, the company can take this cover out. Here, we consider one method of shareholder protection – company share purchase – along with the tax implications.

Company share purchase arrangement

The company takes out life and/or critical illness protection policies for each of its shareholders with a benefit amount that reflects the value of each shareholding. These would usually be taken out until their normal retirement date.

When a shareholder dies or becomes critically ill, the policy proceeds are paid to the company, giving it the necessary capital to buy the shares of the outgoing shareholder. There's no need to write these policies in trust for this to be an effective arrangement.

Option agreement

While the arrangement so far provides the company with funds to allow it to buy the shares, there should be a written agreement between the company and its shareholders setting out the terms of a potential share purchase.

Commonly the agreement will take the form of an option agreement. This is to maintain any business property relief that the outgoing shareholder's entitled to. This is an important relief as it can mean that the value of the shares, or indeed the cash payment received for the shares, isn't subject to inheritance tax.

You can use a double option (also called a cross option) agreement for this, but a single option agreement might be preferable. This is because of the solvency statement that the directors would have to give before a share purchase can take place. This is a statement that each of the directors believes that the company will be able to meet its obligations and discharge its debts over the next 12-month period, or in the event of its winding up. The continuing directors might not be able to make this statement if the outgoing shareholder or their family has an option to sell and chooses to enforce the option (the double option method). A suitably qualified solicitor should draft the agreement.

Taxation of policy payments and proceeds

As the company is the policyholder of the life and/or critical illness cover, it will make the policy payments. It won't receive any corporation tax relief on these payments because the policy isn't designed to meet loss of profits when the outgoing shareholder dies or becomes critically ill. In other words, the policy payments don't meet the 'wholly and exclusively for the purpose of the trade' rule. As the company owns the policy and makes the policy payments, there are no tax implications for the shareholders.

When a claim is successfully made, the policy proceeds are paid to the company and shouldn't be liable for corporation tax as they're treated as a capital rather than a revenue receipt. If the company receives the policy proceeds, the share value might increase as a result of this cash injection. The outgoing shareholder might want to take this into account when determining the value of their shareholding.

Legal requirements

A number of legal requirements must be met before a company share purchase out of capital can take place. These are set out in Part 18, Chapter 4 of the Companies Act 2006. These were partially amended by Statutory Instrument 2013/999, which came into force on 30 April 2013.

The main legal requirements are:

- a company can buy its own shares unless this is specifically restricted or prohibited by its Articles of Association. This is helpful as the Articles of some older companies don't provide the necessary authority;
- the contract to buy shares must be authorised by a simple majority (more than 50% of the voting rights) before any share purchase;
- the company can buy small amounts of shares using capital or cash, as long as it doesn't exceed the lower of £15,000 or 5% of the value of its share capital without having to identify the cash as being from distributable reserves;
- if capital's being used to buy the shares, the shareholders will have to authorise this by special resolution (75% of the voting rights) 15 days before the funds leave the company;
- the shares must be paid for when they're purchased;

- where a company buys shares it must deliver a return to the registrar of companies within 28 days, beginning on the date it receives the shares, and
- the shares purchased must be cancelled so that they become unissued share capital. The company must tell the registrar of companies about this cancellation within 28 days, beginning on the date it receives the shares. It must also include a statement of capital.

There are also other matters that you need to consider:

- the directors must make a statement about the solvency of the company and attach to it a report addressed to the directors by the company's auditors;
- within the week after the share purchase has been authorised, the share purchase must be publicised in the London Gazette plus either a national newspaper, or give notice to each of its creditors, and
- as capital is leaving the company, it can get clearance under section 1033 Corporation Tax Act 2010 for the transaction to be given capital gains tax treatment.

The authorised share capital (the maximum amount of share capital that a company's permitted to issue to shareholders) is unaltered while these shares become unissued share capital. This effectively increases the proportionate shareholdings of the remaining shareholders. Let's look at an example to see what this means in practice.

Example

A company has an issued share capital of 100 shares, with each of its four shareholders owning 25 shares, or a one-quarter interest. When a shareholder dies or becomes critically ill, the company buys their shares and they're cancelled. This would leave 75 shares, with each shareholder now having a one-third interest.

Tax treatment of company share purchase

When the company receives the policy proceeds it won't be liable for corporation tax. However we need to consider the tax implications when the company uses the policy proceeds to buy the shares. Generally any excess paid over the original cost of the shares will be treated as a distribution by the company. For the outgoing shareholder the distribution is treated as a dividend, and this is liable for income tax at their highest tax rate.

The excess won't be treated as a distribution if various conditions are satisfied. These conditions are contained within sections 219-229 ICTA 1988 and section 1033 Corporation Tax Act 2010. Instead capital gains tax (CGT) treatment could apply. A company intending to make a share purchase can apply to HMRC for advance clearance confirming whether CGT treatment will apply or not. Generally CGT treatment could be preferable as the CGT rates for the 2018/19 tax year are 10% or 20%, compared with income tax rates on dividends of 7.5%, 32.5% or 38.1%. HMRC has a statutory deadline of 30 days to respond. Entrepreneur's relief might be available, reducing the CGT rate from 20% to 10%. The amount of gains subject to the relief is £10 million for the 2018/19 tax year.

When a shareholder dies there's an automatic tax-free uplift on the value of shares for CGT purposes. This could result in there being no gain on the disposal in situations where the date of death value (the base cost) is equal to the selling price.

The following conditions for CGT treatment must be met:

- the company must be an unquoted trading company or holding company of a trading group. Investment companies are excluded;
- the vendor must be UK resident and have owned the shares for a period of five years. This period might be reduced in limited exceptions such as where the outgoing shareholder acquired the shares under the will of the previous owner, or in exchange for other shares as part of a company reconstruction;
- the vendor's interest must be eliminated or substantially reduced as defined by HMRC;
- the purchase must be for the benefit of the company's trade or its subsidiary, and
- the purchase must not be part of a tax avoidance scheme.

HMRC's [help sheet](#) provides more information about the conditions that must be met before the payment can be treated as an exempt distribution.

Summary

When a shareholder dies or becomes critically ill, the continuing shareholders might need a cash payment so that they can buy the outgoing shareholder's shares. This can be done in different ways using life protection policies. A company share purchase could be attractive as the policy payments are made by the company rather than the shareholders. While the company won't get tax relief on the policy payments, there's no cost to the shareholders. This might be cheaper than alternative methods of shareholder protection where the individual takes out a policy and the company makes the policy payments with no reimbursement from the shareholders.

A company share purchase is relatively easy to set up as there's no need for a trust, although a bespoke option agreement drawn up by a solicitor is required. There are a number of legal conditions that must be met before a share purchase can take place. As these conditions must be satisfied at the time of purchase, there's an element of uncertainty as to whether this method of shareholder protection will achieve the objective, which is for the company to buy back the shares from a deceased shareholder. It's important that the company takes advice before adopting this method of shareholder protection, and involves its auditors, tax advisers and lawyers throughout.

If you need any help with this, please speak to your usual Aegon sales representative or visit [our website](#) for more business protection support.