

PARTNERS WEALTH MANAGEMENT

AN INTRODUCTION TO

Shareholder Protection

AREAS WHERE WE WORK CLOSELY ALONGSIDE YOUR LEGAL ADVISERS

PUTTING IN PLACE THE PROTECTION TO FUND THE SHARE SALE/PURCHASE



The question “what happens if a shareholding director passes away or is unable to return to work following diagnosis of a critical illness?” should be a key part of a company’s succession planning. This is a complex area, and this guide is designed to highlight areas to consider.

The aim of shareholder protection insurance is to provide the following in the event of the death or critical illness of a shareholding director:

- Funds to the remaining shareholders to purchase some or all the shares from the deceased/critically ill shareholder or their estate, so that they can retain control of their business
- Funds to help them move forward with financial freedom, at an extremely difficult time, so that the deceased/critically ill shareholder or the estate can sell their shares in the business for a fair value.

To meet these objectives, we are very comfortable to work alongside your legal and accounting advisers to put the following components of this strategy in place:

- a share purchase agreement
- an appropriately drafted will
- standalone life cover or life insurance combined with critical illness cover.

We will also effect the cover in the most tax efficient manner.



We're here to help

We're only a phone call or email away. If you would like further guidance or advice on shareholder protection, please do get in touch.

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Areas where we work closely alongside your legal advisers

A share purchase agreement

A limited company's articles of association, or a firm's partnership agreement, will normally state what should happen in the event of a shareholder's death or illness. In many cases, these agreements give a 'first refusal' right to allow existing shareholders to purchase shares from a co-shareholder; but they are unlikely to provide necessary compulsion for purchase of shares. To overcome this, an agreement stating terms for the purchase of the shares between shareholders in the event of death or critical illness is also required to sit alongside this. Care must be taken to ensure that the terms of the agreement do not conflict with the company's articles of association, and we work with your legal advisers to this end.

Furthermore, these terms should not bind the parties, otherwise HMRC are likely to treat this as a contract for sale and disqualify it from inheritance tax business property relief on share disposal, meaning that the deceased shareholder's estate may inadvertently have more tax to pay on their death.

The agreement for share purchase will take the form of either a double option (or cross option) agreement, or a single option agreement between the shareholding directors.

Double option agreement

This type of agreement allows both parties to have the option to buy (remaining directors) or sell (estate of the deceased/legal representatives) the company shares.

If either party exercises their option, the other party must comply. As this is an option for either party to exercise, inheritance tax Business Relief should be available, provided the deceased's shareholding meets the relevant criteria for the relief (again we would review alongside your lawyer).

Business owners should be mindful that the Budget announcements in October 2024 have changed Business Relief from April 2026. We strongly recommend that business owners contact us for advice on the impact this could have on their shareholder protection and legacy plans.

Single option agreement

This type of agreement will usually be used if a shareholder suffers a critical illness. It only provides the critically ill shareholder with the option to sell their shares to their co-shareholders.

Importantly, there is no option for the remaining shareholders to purchase the shares, meaning the critically ill shareholder retains control over their shareholding and cannot be forced to sell. This is key as it could be possible that they might fully recover and return to work.

It is also possible to draft a double option agreement to become effective in defined circumstances, should a shareholding director become critically ill, for example, in the event of total or permanent disability.

An appropriately drafted Will

It goes without saying that having a Will is a key part of anybody's financial planning. However, in the context of share purchase agreements, all shareholders party to the arrangement should ensure that their Wills are drafted to leave their shares to their spouse/civil partner, their children or other beneficiaries they choose.

Dependent on the type of business, business property relief (for inheritance tax) may also apply where shares are not left to the spouse. In these cases, it would be possible to direct the shares into a discretionary trust, which then bypasses the surviving spouse's estate but allows them access as a potential beneficiary. The benefit of this is that it could avoid an inheritance tax liability arising on the second death, where a surviving spouse would have otherwise received the shares directly and subsequently disposed of them (i.e. the funds received from the sale would otherwise be added to the value of the spouse's estate). Again, we would collaborate with your legal team on this.



Putting protection in place to fund the share sale/purchase

Ensuring sufficient cover

A 'life' or 'life and critical illness' insurance policy will provide funds for the shareholders to purchase the shares of a deceased/critically ill shareholder from their family. It is important that the level of cover chosen reflects the value of the shares, and we would work alongside you and your accountant to ensure that we obtain an accurate valuation.

Setting the contract up

The insurance policy should reflect who will be purchasing the shares, and the method chosen should be consistent with the company's articles of association.

In most cases, there are two methods of setting up the contract:

- Own life in trust
- Life of another

Own life in trust basis

This is the most common method and requires each participating shareholder to take out a policy on their own life, for the value of their own share in the business. The policy is written under a business trust from outset, for the benefit of the other participating shareholders who will normally be appointed as trustees.

In the event of a death claim, the policy proceeds will be held by the trustees and is normally payable to the beneficiaries proportionate to their entitlement to the deceased's shareholding. In the event of a critical illness claim, the insured may choose not to exercise their option to sell, in which case the trustees would retain the proceeds within the trust until funds were required to purchase the critically ill shareholder's interest.

Life of another basis

This is not often used, as most prefer the flexibility granted by the alternative. Due to complexity, it will mostly be used by smaller businesses with no more than two shareholders.

Where this is used, each shareholder takes out a policy on the life of each of the other shareholders, with the level of cover reflecting the value of the other's shareholdings. Upon death or diagnosis of a critical illness, the policy benefits are paid directly to the other shareholders, providing funds to purchase the deceased or critically ill shareholder's share of the business.

To highlight, where there are a large number of shareholders, the number of policies that would be required to cover each other would quickly become unwieldy compared to the 'own life in trust' method. In addition to this, there is no flexibility should a shareholder leave, or others join the business.

The need for commerciality

Assuming that the 'own life in trust' method is employed, the need for commerciality is important to avoid potential inheritance tax problems.

Normally, payments made to a policy held in a trust will be treated as gifts for inheritance tax purposes. However, if the arrangement is deemed to be commercial and reciprocal, these premium payments will not be treated as such.

To demonstrate commerciality, the provisions of the trust should:

- Stipulate that beneficiaries are restricted to the shareholding directors taking part in the arrangement (or those who may become shareholding directors). Therefore, unless they are shareholders participating in the agreement, it is not possible to include spouses or other family members as potential beneficiaries
- Require each beneficiary to establish and maintain their own life cover at the agreed level, in an equivalent trust for their co- shareholders.

In addition, the cost to all participating shareholders should be proportionate to their expected benefit – this is expanded upon below.

A commercial arrangement has an additional benefit, as the settlor is able to be included as a beneficiary under their own trust. This enables them to have the policy assigned back to them if they leave the business, which could be extremely important should the leaving shareholder have insurability issues, but require life assurance protection from a personal perspective.

Premium equalisation

It is not unusual for businesses to have a number of shareholders, all of whom are different ages, different states of health and own different share holdings (and subsequently require different levels of insurance). On this basis, some shareholders could be paying more for their insurance policy, but receive less benefit from the arrangement.

In such circumstances, where a significant difference between costs and benefits exists, premium equalisation becomes important to ensure that HMRC do not view the situation as a gift from one shareholder to another, which could then lead them to conclude that the arrangement is non-commercial. Premium equalisation effectively means that the cost of premiums in the arrangements more accurately reflect the benefits each shareholder would expect to receive.

For further information

We trust this has helped you to understand a potential issue that you might need to consider within your business, and demonstrated that we have the expertise to assist you with this. We would be happy to address any of the topics mentioned here in greater detail.

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