Reference

HIBERNIAN

# Company Buy Back Insurance

## A) Important

This guide is based on information supplied and on our understanding of current legislation and Revenue practice.

### Important

Shareholders must seek professional advice from their own legal and taxation advisers to ascertain whether Company Buy Back Insurance is likely to be effective in the circumstances of their company and their personal circumstances.
Hibernian Life and Pensions do not accept any responsibility for actions taken on the basis of this guide.

# b) The breakup of a business

## Working together

A successful company will only grow and be successful, when the directors involved in that business work well together.

Conversely, when the directors involved do not work well together or do not get on with each other, the business can frequently fail.

## The breakup

In addition to the personal tragedy for all concerned the death of a company director causes major problems for :

the surviving directors, and

the deceased's next of kin.

## The surviving directors

The other directors face a number of potential difficulties :

**a new business partner.**
The deceased's shares may pass through his estate to a new owner, possibly the deceased's spouse or one of his children. The new owner may not have any detailed experience of the business.

**loss of control.**
If the deceased director owned more than 50% of the company the surviving directors will have to work with a new majority shareholder, possibly the deceased's spouse. There could be disagreements about how the business should be run.

**inability to buy out the new shareholder.**
The ideal solution, from the other directors point of view, might be to buy back the deceased's shares. But where will they get the liquid capital to do this? And what if the next of kin refuse to sell?

## The next of kin

The next of kin may also find themselves in a difficult position.

**No ready market for the shares.**
The company's Articles of Association may give the other shareholders the right to block the sale of the shares to an outside party. Without any way to sell the shares on the open market at their true value, the deceased directors next of kin could be forced into a fire sale of the shares to the other directors, at a low price.

**Cash flow difficulties.**
The deceased's salary will cease on death. If the shares are not sold, the next of kin may be left holding a paper asset, particularly if they now own a minority holding in the company, producing little or no income. The cash flow problem could be exacerbated if the shares inherited also give rise to an immediate Inheritance Tax liability.

## Serious Illness

The onset of a sudden serious illness of a director could give rise to a situation similar to that arising on death :

the ill director may want to sell his shares and realise a lump sum in order that he may retire from the business.

the other directors may not have the necessary capital available at that time to buy back the shares.

# c) Company Buy Back Insurance

## Providing a solution

Company Buy Back Insurance is a means of solving the financial problems that can arise following the death of one of the shareholding directors. An outline of the arrangement is :

The company enters a Contingent Purchase Contract with each shareholding director, so that in the event of his or her death, the company would acquire an option, which it can exercise within a limited period after death, to compel the deceased's next of kin to sell their shares back to the company at a fair open market value. Likewise the deceased's next of kin would also acquire an option to compel the company to purchase the shares from them. In this way either the company or the deceased's next of kin can trigger the purchase/sale of the deceased's shares after death.

Hibernian Life and Pensions can make available a copy of a Specimen Contingent Purchase Contract. However this must be referred to the company's own legal advisers in order that they can draft a contract suitable to the company's own specific circumstances.

The company effects a life assurance policy on the life of each director covered by such an Agreement, to provide funds on death to enable the company to complete the buy back of shares. The company pays the premiums.

In the event of the death of a director covered by such a Contingent Purchase Contract, the company would use the proceeds of the policy on his life to buy back his shares on death and cancel them, or hold them as 'treasury shares'. The surviving shareholders would therefore retain full ownership of the company.

However the arrangement is complex, and may not be appropriate in every case. Only a very brief outline has been given here. More details are set out in the following Chapters of this Report.

## The Benefits

The Company Buy Back Insurance arrangement brings benefits for both sides, in the event of the death of a director :

the next of kin are not locked into the company, and can rapidly realise their shares for a substantial capital lump sum,

the surviving directors retain full control over the company as the company buys back and cancels the shares of a deceased director.

the cost of the life assurance is borne totally by the company, with no personal outlay for the directors.

## Restrictions

There are two main areas that may restrict the use of Company Buy Back Insurance and hence should be considered carefully before entering into such an arrangement :

The legal power of a company to purchase its own shares, and

The taxation treatment of the buy back of the company's own shares.

Both of these issues are considered in more detail.

# d) The Legislation

## Companies Act 1990

The Companies Act 1990 allows a company to buy back its own shares in certain circumstances, and subject to certain restrictions.
There are a number of restrictions that must be considered, including :

A company can only purchase its own shares if its Articles of Association allow it.

A company can only purchase its own shares under a contract entered into in advance of the purchase, which must be approved by a Special Resolution.

A company cannot buy back all its own shares.

Only fully paid up the company may purchase shares.

A company purchasing its own shares must pay in full for the shares at the time of purchase.

A company can only buy back its own shares out of profits available for distribution, as defined in the Companies Act 1990.

Copies of the contracts of purchase of the shares must be kept at the company's registered office for a period of 10 years after the share buyback.

The company must make a return to the Register of Companies of details of the number and class of shares purchased, their nominal value and the date on which they were delivered back to the company.

# e) Taxation

## The company

As part of the Company Buy Back Insurance arrangement, the company will be required to effect and maintain a policy on the life of each shareholding director who is to be a party to a contingent purchase contract with the company. Under current Revenue practice:

the premiums on such policies are not allowable deductions for Corporation Tax purposes.

The proceeds payable on death would not be subject to the exit tax applied to the proceeds of life assurance policies, as a death benefit payout is not a chargeable event for the purposes of the life policy exit tax.

the proceeds payable on death, would be treated as a realised capital receipt in the hands of the company, and exempt from Capital Gains Tax provided the sole purpose of the policy is to provide funds to enable the company to purchase its own shares.

if the buy back of the shares is deemed to be a distribution (see the following paragraph) then the company would be deduct Dividend Withholding Tax at standard rate on the payment.

## The director and next of kin

### Distribution

Under S.84 of the Corporation Tax Act 1976, where a company redeems its shares, any amount paid by the company in excess of the original issue price is treated as a distribution for tax purposes. There are two implications if this treatment were to apply to the purchase by the company of its own shares:

he company would have to deduct Dividend Withholding Tax at standard rate on the amount paid for the shares, and

the vendor of the shares would be liable to income tax at marginal rate under Schedule F on the amount of the net distribution received plus Withholding Tax, but with a credit allowed for the Withholding Tax deducted at source.

### Not a distribution

However under provisions of the Finance Act 1991, the purchase by a company of its own shares is NOT treated as a distribution if all of the following apply :

the company must be an unquoted trading company, or the unquoted holding company of a trading group,

the purchase of the shares is made wholly or mainly for the purpose of benefiting a trade carried on by the company. There is no Revenue guidance as to what would constitute being for the benefit of the trade,

the purchase of the shares must not form part of any scheme or arrangement the main purpose of which is to enable the owner of the shares to participate in the profits of the company without receiving a dividend. Where shares are being bought back after the death of a shareholder, it is clear that the intention of such a buy back is not to avoid taking dividends, but rather to facilitate the disposal of the shares by the next of kin,

the vendor must be resident and ordinarily resident in the State for the year in which the company purchases the shares. The residence and ordinary residence of the deceased's personal representatives are taken as those of the deceased shareholder, immediately before his or her death, the shares must have been owned by the vendor for at least 5 years before the shares are purchased, or 3 years where the shares are being purchased after the shareholder's death. The period during which the deceased's personal representatives own the shares also counts towards the 3-year ownership requirement,

the vendor and his associates, i.e. spouse, if living together ,and children under age 18, must reduce their shareholding after the purchase by the company, by at least 25%. Where all of a vendor's shares are being bought back by a company, and his associates have no other shareholding in the company, then this requirement will clearly be met,

the vendor and his associates combined must not be connected  with the company after shares are sold to the company. This means that after the buy back , the vendor and his associates combined must not own or control more than 30% of the equity of the company. Where the deceased's full shareholding is bought back by a company, and his associates have no other shareholding in the company, then this requirement will clearly be met.

## Capital Gains Tax

Where all of the seven tests outlined above apply, then the sale of the shares to the company is treated as a disposal for Capital Gains Tax purposes, and not as a distribution.

For Capital Gains Tax purposes, shares on death are deemed to be acquired by the next of kin, at their market value at the date of death. There is no Capital Gains Tax liability on death.

If the next of kin sell their shares shortly afterwards to the company, a liability to Capital Gains Tax on the shares would only arise in respect of any increase in the value of the shares from the date of death to the date of disposal.

## Loss of Business Relief

Please also note that the disposal of the shares by the next of kin shortly after death will result in the loss of any Business Relief applicable to those shares for Capital Acquisition Tax (CAT) purposes. Where the spouse of the deceased would have inherited the shares sold, then no Inheritance Tax would have applied anyway, and so any loss of Business Relief in this case would be immaterial.

Where, however, the shares sold back would have been inherited by some other beneficiary, .e.g. a child of the deceased, the potential loss of Business Relief for CAT purposes may be significant and hence should be borne in mind before entering into a Corporate Co-Directors Insurance arrangement.

# f) Arranging the Corporate Co-Director's Insurance

There are a number of steps involved, in setting up a Company Buy Back Insurance arrangement:

## Who should be included?

All shareholding directors should be considered for inclusion.

## Check the Capital Gains Tax treatment will apply

The circumstances of each director to be included in the arrangement, should be checked in order to verify whether all of the seven tests outlined in the previous section of this Report, will be likely to apply on the purchase of his or her shares by the company on death.

If a particular director's circumstances are such that all seven tests are unlikely to be met, then strong consideration should be given to excluding that director from the Company Buy Back Insurance arrangement, as the taxation treatment of the shares purchase price as a distribution is likely to be unattractive for all parties concerned.

It is important that all parties to be involved in the arrangement are satisfied that the Capital Gains Tax treatment will apply on the sale of the shares to the company before the Company Buy Back Insurance arrangement is set up.

## Examining the company's Articles & Memorandum of Association

The company's Articles of Association may need to be changed in order to provide a power for the company to buy back its own shares.

The company's Memorandum of Association may also need to be changed to specifically include an object permitting the payment of premiums under a Company Buy Back Insurance arrangement.

## Check Profits available for distribution

The directors and its auditors should check that the company has a positive pool of profits available for distribution and hence the company will be able to buy back its own shares to the fullest possible extent.

If there is currently a negative pool of profits available for distribution, then all parties involved should realise that in the event of the death of a director covered by the arrangement, the company may not be able to fully purchase his or her shares, even though it receives the full benefit of the policy on that director's life.

## Prepare Contingent Purchase Contract

Assuming that the company's Articles and Memorandum of Association have been amended to allow the company to buy back its own shares and to effect life policies as part of such an arrangement, the company in conjunction with its own legal and taxation advisers, would then prepare a separate Contingent Purchase Agreement, in respect of each shareholder to be included in the arrangement.

As pointed out earlier, Hibernian Life and Pensions can make available a specimen Contingent Purchase Agreement, but this agreement should not be used as it stands and should be referred to the company's own legal and taxation advisers to draft an agreement suitable to the company's own circumstances.

Each contract should specify that it terminates automatically on death and repurchase of any other director's shares.

## Company proposes for policies

At this stage, the company would propose to Hibernian Life and Pensions for a policy on each director to be included for the level of cover on each director equivalent to the fair open market value of his shares.

## Meeting to authorise company to enter Contingent Purchase Contract

At this stage the special meeting is called in order to pass a special resolution of the members, to authorise the company to enter into a Contingent Purchase Contract with a shareholding director. A separate resolution is required in respect of each proposed Contingent Purchase Contract.

A copy of the contract must be available for inspection by shareholders at the registered office of the company for at least 21 days before the meeting.

The resolution will be ineffective if the shareholder who is a party to the relevant Contingent Purchase Contract votes in favour of the resolution and without his or her votes, the special resolution would not have been passed.

The terms of a purchase contract may only be subsequently varied, revoked or renewed by a further special resolution.

## Issue of the policy

When each proposal is accepted and the first premium is paid to Hibernian Life and Pensions, each policy is issued to the company.

## Completion of Contingent Purchase Contract

The final step, once the life assurance policies are in place, is for the company and the relevant directors to sign the relevant Contingent Purchase Contract. The Company Buy Back Insurance arrangement is now in place.

# The power of company to buy back its own shares

## Articles of Association

Before entering into an arrangement to purchase its own shares, the company's Articles of Association need to be reviewed and possibly changed to ensure that the Articles contain a specific provision empowering the company to purchase its own shares.

Such a change to the company's Articles would need to be approved by a special resolution.

## Contingent Purchase Contract

Under the Companies Act 1990, a company can only purchase its own shares under a contract entered into in advance of the purchase and authorised by a special resolution of the shareholders.

The Act allows a company to enter a contingent purchase contract, i.e. a contract under which the company would buy back its own shares in the event of the happening of a specified contingency, e.g. the death of a specified shareholding director.

There are three important requirements for this contract to be valid :

A copy of the contract must be available for inspection by shareholders at the registered office of the company for at least 21 days before the meeting at which the special resolution will be put to enter into such a contract.

The special resolution will be invalid if the shareholder who is a party to the contract votes in favour of the resolution and without his votes, the special resolution would not have been passed.

The terms of a purchase contract may only be subsequently varied, revoked or renewed by a further special resolution.

A special resolution requires at least 75% of the votes of those who 'being entitled to do so, vote in person'. Therefore if the shareholder who is to be a party to a Contingent Purchase Contract with the company owns more than 25% of the voting shares of the company, that shareholder must absent himself from the meeting to approve that special resolution, in order that the other shareholders may pass the resolution validly.

## All shares may not be purchased

The Companies Act 1990 does not allow a company to purchase all its own shares, and hence effectively liquidate itself.

S.211(3) of the Act provides that a company may not purchase its own shares if as a result of the purchase, the nominal value of the issued share capital not bought back or redeemable, would be less than 10% of the nominal value of the total issued share capital of the company.

For this reason, therefore, a Contingent Purchase Contract will usually limit the obligation of the company to purchase the shares of a deceased shareholder, to the extent that it can lawfully do so.

## Profits available for distribution

Section 211(3) of the Companies Act 1990 provides that a company can only purchase its own shares 'out of profits available for distribution'.

This term is defined as accumulated realised revenue and capital profits less accumulated realised revenue and capital losses. For the purpose of ascertaining the availability of profits, a company's affairs are treated without reference to individual accounting periods and as being continuous.

Therefore a company in computing what profits are available for distribution, and hence the extent to which it can buy back its own shares, must also take into account any losses which may have accumulated over the years.

However the proceeds of a life assurance policy owned by the company, payable on death, as part of a Company Buy Back Insurance arrangement, would under current Revenue practice, be deemed to be a realised capital receipt, and hence would swell the pool of profits available for distribution for a company purchase of its own shares.

Because of this restriction, a Contingent Purchase Contract will usually limit the obligation of the company to purchase the shares of a deceased shareholder, to the extent that it can lawfully do so.