

## Share purchase on death

Synopsis: Component parts of a share purchase plan.

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To ensure that the arrangement for share purchase satisfies all of the objectives of the shareholders, it should be recommended that all the necessary component parts of the plan are taken care of. These include the following...

### Wills

To ensure that no delay is suffered by intestacy, all parties to the plan should execute Wills directing who should be entitled to the shares or the proceeds of any sale.

If 100% business relief (BPR) is available (as it would be in most cases) then the shares given could be left to a discretionary 'by-pass' trust so that the children and the surviving spouse/civil partner of the shareholder could benefit. The trustees would, typically, have a wide power of appointment and power to lend to any discretionary beneficiaries, including the surviving spouse or civil partner.

In this way, access to the proceeds of sale for the surviving spouse/surviving civil partner would be secured through advancement or (preferably) loan whilst keeping the value of the inherited shares out of the surviving spouse's/surviving civil partner's estate for inheritance tax (IHT) purposes. For the debt on the spouse's/civil partner's estate to be deductible for IHT, the debts should actually be repaid from the spouse's/civil partner's estate on their death.

This type of trust is often referred to as a 'spousal by-pass trust'. In order to minimise the likelihood of IHT periodic and exit charges if the shareholder is planning on using a discretionary trust, say to use the nil rate band in their Will, it may be worth considering establishing the trust during lifetime to avoid the (generally detrimental) associated settlements provision that can lead to higher tax charges.

A lifetime trust set up with the specific intention that substantial assets are added to it at a later date, following the death of the settlor in this case, is usually referred to as a "pilot trust". Such a trust is normally set up with a nominal amount to ensure there are no immediate IHT implications.

To ensure that the business assets or proceeds of the sale of the business assets pass to such a pilot trust, it is necessary to ensure that certain transactions are carried out in a particular order. To begin with, the option agreement must always be executed first. Secondly, the pilot trust should be executed and a nominal amount transferred to the trustees. The last step should always be the Will or codicil under which the business assets pass to the pilot trust.

If the option agreement was executed after the Will was made, and, after the death of the testator, the option to sell is exercised, the legacy of the business interest will

not fall into the trust but it into the residue of the deceased's estate. Thus, the objective of the testator will not be achieved.

### **The by-pass trust**

The by-pass trust we have in mind here is one created with a nominal amount by a business owner with the intention that the share or shares they own in a private business (their business interest) will pass to the trust following their death. However, what happens if the business interest is also subject to an option agreement for sale / purchase between the owner and their co-owners in the business? The same rules will apply regardless of the nature of the business, i.e. limited company, LLP or a partnership.

Typical option agreements for the sale / purchase of business interests would normally be drafted along the lines that their terms would bind the parties to the agreement as well as their legal personal representatives. Under a typical agreement, the legal personal representatives of the deceased (i.e. executors or administrators) would have an option to sell the business interest following the death of the owner to their co-owners and there would be a corresponding option granted to the co-owners to purchase the business interest.

It is essential that the agreement is not a binding agreement for sale as this would deny BPR for IHT purposes. However, as long as one of the parties chooses to exercise their option, the other party would be compelled to carry out theirs and so the sale / purchase would go ahead.

There would normally be a specific Will legacy of the business interest, failing which, i.e. if there is no specific legacy, the business interest would fall into the residue.

If a by-pass trust is used, there would normally be a lifetime trust created with the intention that the business interest passes to this trust.

The question then arises as to whether there may be a conflict between the legal personal representatives having an option and perhaps being obliged to sell the business interest to the co-owners on the one hand and the legacy which may be expressed as a gift of the business interest to the trust on the other hand.

Indeed, the same considerations would apply if the legacy is not to a trust but to another individual, say, the children of the deceased. Is it always clear that the proceeds of any sale of the business interest, assuming that the sale takes place under the option agreement, would be transferred to the trust?

Here are the general principles of how such an arrangement should work...

If there is an option agreement which has been entered into by the deceased, this would bind their executors.

The next question to address is whether the legacy (to the trust, if a pilot trust has been set up) will fail if it is expressed as merely a legacy of the business interest. If

the legacy fails then the proceeds of sale will pass into the residue of the estate rather than to the trust.

The general rule is that a specific legacy will fail if the subject matter of the legacy does not form part of the deceased's estate at the date of death. This is referred to as 'ademption'.

The relevant time is the testator's death, but ademption will also occur if, following the execution of a Will, the testator enters into a binding contract for sale in connection with the asset that is the subject of the legacy. However, option agreements are not considered binding contracts for sale.

What are the rules for option agreements?

Fortunately, there is helpful case law on these matters.

The conclusion from the case law is that if the option is granted (i.e. the option agreement is entered into) before the Will is executed (or republished by codicil), the testator is deemed to gift to the beneficiary the property or the proceeds thereof. However, if the option agreement is executed after the Will, and after the death the option is exercised, the legacy will be adeemed and the proceeds will fall into the residue and not go into the trust.

From the above it should be clear that where business owners are entering into option agreements for sale and also intend to carry out wider IHT planning with the use of a by-pass trust executed during lifetime and an appropriate Will provision, the order of transactions is crucial.

The option agreement must always be executed first. Second, the pilot trust should be executed and the nominal amount transferred to the trustees. It is essential that no powers of appointment should be exercised under this trust after the Will or relevant codicil has been executed although, of course, with only a nominal amount held in the trust this should not be necessary.

The last step should always be the Will or codicil.

If the trust terms need to be changed for some reason, a new Will / codicil will have to be made (or the existing Will republished) subsequent to that, if the legacy to the trust is to stand.

It is, of course, possible for individual testators to make much more precise Will provisions with regard to their business assets and confirm, for example, that the legacy should include the proceeds of any sale by the executors, i.e. on sale taking place after the death of testator.

It is always essential that proper legal advice is taken when drafting and executing a Will.

The above explains the order of events and how the arrangements should be made. If the order of events is wrong or the Will provisions are not drafted correctly, the objectives of the settlor may inadvertently not be satisfied.

### **The agreement for purchase**

The agreement for purchase should be in the form of a double (or 'cross') option agreement between the shareholders to ensure that, in effect, if either party wishes to buy or sell (as appropriate) the surviving shareholders will buy, and the personal representatives will sell, the shares but BPR at 100% is maintained.

The effect of the double option agreement is that the agreement is not binding and therefore BPR for IHT is not lost, yet if one party decides to exercise their option the other party will be bound to sell or purchase as appropriate. The double option agreement must be consistent with the company's Articles of Association.

### **Life assurance**

A life assurance policy, combined with critical illness cover where appropriate, will be required in order to ensure that cash is available to make the share purchase at the desired time.

### **The trust for the life assurance**

A trust of the life assurance policy is required to ensure that the cash is placed in the right hands at the right time, in the most tax efficient way possible. Special business protection trusts are usually used which provide that the surviving shareholders will benefit from the policy proceeds in the proportions, generally speaking, in which they will be expected to effect the purchase.

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