# Option agreements

Synopsis: The effect of double and single option agreements.

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**Double option agreement**

For a company, a double option agreement for share purchase on death will provide that, if a shareholder dies, the surviving shareholder(s) will have the option to buy and the personal representatives of the deceased shareholder will have the option to sell, the deceased's shares. The agreement can specify the proportion of the deceased shareholder's shares that each survivor is to buy. Usually, this will be a reflection of the sizes of their own shareholdings.

It must be ensured that any share purchase agreement does not conflict with the company's Articles of Association.

For a partnership, a double option agreement for purchase of the partner's interest on death will provide that, if a partner dies, the surviving partners will have an option to buy and the personal representatives of the deceased partner will have an option to sell the deceased's share of the partnership.

The agreement can specify the proportion of the deceased partner's interest that each survivor is to buy - usually this will reflect the proportions in which they will continue to own the business.

A double option agreement may be incorporated in the partnership deed or it can be separate, but it must be ensured that it does not conflict with the partnership deed.

The options will typically be exercisable within specified periods, e.g. three or six months from death or payment of the policy proceeds so as to reinforce that the agreement is a genuine option agreement and not, in effect, a binding agreement.

Although the objective of the agreement is that, should either side so elect, the surviving shareholders (in the case of a company) or surviving partners (in the case of a partnership) will buy and the personal representatives will sell the deceased's shares or share of the business, the terms of the agreement should not be obligatory.

This is because HMRC regards such an agreement as forming a binding contract for sale and thus makes the transfer of shares or a share of the business on death ineligible for business relief (BPR) for inheritance tax purposes (i.e. the property in the deceased's estate will effectively be regarded as cash rather than shares or a partnership share).

With the rate of BPR applying to all shareholdings in private limited companies, regardless of size, and all partnership interests, at 100% (subject to the usual requirement for two year ownership), it is absolutely essential that the relief is not denied (of course, it may not matter if the shares or share of the business were to

otherwise pass to the deceased's spouse or civil partner because of the spouse / civil partner exemption, but it cannot be guaranteed that the spouse or civil partner will survive the director/partner, and, for other inheritance tax planning reasons, the transfer of shares or a share of the business under a Will may well not be made to the spouse or civil partner).

HMRC accepts that a double (or cross) option agreement is not a binding contract for sale and does not prejudice BPR (Statement of Practice SP12/80).

This is so, even though the effective result of the double option agreement is that, as long as one party to the agreement exercises their right to sell or purchase, the other party will be bound to comply. Unless both parties decide not to exercise their options, the practical effect of the agreement is the same as a buy and sell agreement but eligibility for BPR is retained.

HMRC was asked for comments on several possible wordings for agreements in an exchange of correspondence between it and the accountancy bodies in 1984, in which guidelines were formulated as to the circumstances in which BPR was accepted as being available.

There is a specific reference to a "double option agreement entered into under which the surviving... [shareholders or surviving partners] ... have an option to buy (a call option) and the personal representatives an option to sell (a put option), such options to be exercised within a stated period after the...[shareholder's or partner's] ...death."

Sometimes, it is felt that there may be a stronger argument in favour of the option agreement not being binding if the option periods for purchase and sale are not identical, for example, an option to sell for six months, and an option to buy for three months from the date of death.

This is so as to reinforce the contention that the agreement is truly an option agreement and not a 'de-facto' binding agreement. There is nothing, however, in the correspondence with HMRC to indicate that they would attach any particular importance to the length of option period.

There was concern that the decision in *Spiro -v- Glencrown (1991)* provided authority for an option to be a contract for sale thereby resulting in no BPR being available. Early in 1996, the Capital Taxes Office (now HMRC Capital Taxes) confirmed that there had been no change in their opinion regarding SP12/80 and that the case would not be cited as an authority for an option constituting a binding contract for sale.

The subsequent case of *Griffin -v- Citibank Investments Ltd (2000)* provides an even stronger argument that a put and call option in identical terms together do not constitute a single bilateral contract. The case had nothing to do with arrangements for share purchase between shareholders or partnership share purchase between partners, but it did concern two identical options and for this reason is of particular relevance.

Citibank Investments Ltd (CIL) in December 1994 sought an investment that would generate funds in the form of capital gains rather than as income liable to corporation tax. CIL purchased two FTSE linked options, on terms that all transactions entered into on reliance of the purchase agreement formed a single transaction. Corporation tax was then assessed for 1994, 1995 and 1996 on the gains arising from the two option contracts. On appeal to the Special Commissioners, CIL contended successfully that the gains arising from the options fell to be treated as capital gains. HMRC then appealed the Commissioners´ decision.

HMRC conceded that each of the two options, if taken separately, would be a "qualifying option" within the meaning of section 128 ICTA 1988 and accordingly any gains would have been exempted from a charge to tax.

However, if the two options fell to be treated as one composite transaction by the operation of the Ramsay principle (which basically means that the Court should not confine itself to the method of assessing the tax consequences of each individual transaction in a composite transaction, but instead should look at the composite result and consequences), as was HMRC´s contention, that would fail to satisfy the statutory definition of a "qualifying option" within the meaning of section 128.

The Court dismissed the appeal and found that the Commissioners had not misdirected themselves in finding that the two option contracts did not constitute a composite transaction. Even if that were not the case, the law as established in Furniss -v- Dawson gave the Court a limited power to reconstruct a series of transactions in appropriate cases outside of which it was not possible to apply the Ramsay principle so as to convert transactions, such as the two options under consideration in the Citibank Investment case, into something different.

Unless the considerations laid down in Furniss -v- Dawson were satisfied (which basically means that there must be pre-ordained series of transaction and there must be steps inserted which have no commercial (business) purpose apart from tax avoidance), there could be no composite transaction to which the Ramsay principle could be applied.

It is therefore generally now considered that the *Griffin* case puts an end to the speculation in relation to whether or not a binding contract for sale exists in respect of relevant business property for inheritance tax, that a put and call option in identical terms together constitutes a single bilateral contract. This relatively little reported case is therefore of considerable importance to financial advisers particularly those offering advice on share purchase arrangements.

Given that using double / cross option agreements is also well established and accepted practice it is not thought that there is a significant risk of the General Anti Abuse Rule (GAAR) applying.

An option agreement would normally also incorporate various other provisions concerning the agreement as to the price to be paid and an obligation to maintain premiums to a policy as well as various administrative provisions.

Unless a fixed price or formula for share valuation is used, the purchase price will normally be the current value of the shares or partnership share. The agreement would normally provide for the appointment of a valuer - usually this will be a practising accountant appointed by all the parties or one appointed at the instance of the party exercising the option.

It is debatable how far such an agreement should go in providing for “what if” situations. An agreement could, for example, provide for an appointment of a designated valuer by the President of the Institute of Chartered Accountants in England and Wales in cases where the parties cannot between them agree on an appointment of a mutually acceptable valuer.

There could also be provisions as to the practical implications of the appointment, including time limits for determining the value, payment of the valuer’s fees, etc. Clearly, the shorter the agreement, the more the issues that may have to be agreed at the time.

The agreement should also include an undertaking by each party to effect a life policy subject to trust for the other parties and to maintain premiums under this policy or to pay a proportion of the premium in accordance with an agreement to ensure commerciality of the arrangement. The agreement would also normally make provision for what should happen in the event of a sum assured payable under the policy being lower or greater than the purchase price. For example, a provision may be made for payment by instalments if additional funds are required or for the excess to be paid over to the deceased’s estate.

There should also be provisions to establish the nature of the agreement, i.e. on whom it is binding and its relationship to any other constituent documents of the company or partnership, such as the company’s Articles or the partnership deed. In principle, the agreement should not override any provisions in the company’s Articles of Association or in the partnership deed.

Where the agreement states that it will only apply in compliance with the Articles/partnership deed, and, in the event, it turns out that the Articles/partnership deed contain conflicting provisions, the provisions of the option agreement will be totally ineffective. The subject of agreeing the price and share valuation is particularly important.

## Single option agreement

A single option agreement, generally used for share purchase taking place in the event of a director or partner retiring as a result of a severe or critical illness, is an agreement which, for a company, gives the critically ill director an option to sell their shares in the business, but there is no corresponding option to buy given to their co-directors, and, for a partnership, gives the critically ill partner an option to sell their share in the business, but again there is no corresponding option to buy given to their co-partners.

If the critically ill director or partner exercises their option, their co-shareholders/co-partners will be obliged to buy. Except for the option period, in all

other respects the terms of the agreement will be similar to the double option agreement (please see above).

For practical reasons, it is usual to extend the option period to one or perhaps even two years from the date of diagnosis or the date of payment of benefits under a critical illness policy. This is so as to give the critically ill individual sufficient time to assess the extent of their illness or their future involvement in the business and their continued ownership of shares, or a share in the business.

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