



Penny Bates considers a useful and tax-efficient exit route for shareholders

Getting their OWN BACK

Companies have been able to purchase their own shares since 1982, and the process can be a useful and tax-efficient exit route for shareholders where there is no third party interested in acquiring the shares, or where other shareholders wish to purchase them but cannot afford to do so, or perhaps on the death of a shareholder. Similarly, it can be used where there is disagreement over the management of the company and a dissident shareholder wishes to sell his holding. These situations are not uncommon in the typical family business, and I shall provide here a brief overview of the company and tax law that needs to be considered.

The requirements for buy-backs are laid down in the *Companies Act 2006*. One of the key requirements is that the company must immediately cancel the bought-back shares, which must be paid for in cash. Failure to comply with all the rules would make the transactions void. The arrangement would therefore be legally unenforceable, meaning that the shares could not be cancelled and effectively would still be held by the shareholder.

The company can only buy the shares:

- out of its distributable reserves; or
- out of proceeds of a fresh issue of shares; or
- out of capital, provided all distributable profits are first used.

Such a buy-back would be financed by the company, but it may need to seek new finance in order to fund the purchase, which would be repaid out of its subsequent trading cashflow.

Company law requirements

There are a number of further company law requirements including (but not limited to):

1. The shares must be paid for on purchase. Payment must therefore be made on completion and cannot normally be deferred (but see later remarks about multiple completion dates).
2. There is no limit on the number of shares that may be purchased, although at least one irredeemable share must be held after the purchase.
3. The purchased shares must be immediately cancelled.
4. The contract must have been available for inspection at the company's registered office for at least 15 days before the EGM.
5. The share repurchase resolution should be passed by a written resolution.
6. The resolution must be filed with Companies House within 15 days of the EGM.

However, CA 2006 does not require a company to have express power in its

articles to purchase its own shares, although its articles may restrict or prohibit a purchase of own shares, but it does require that the share repurchase contract must be retained at the registered office for a period of 10 years.

Purchase from distributable reserves

A capital redemption reserve, which is non-distributable, must be set up to the extent that shares are purchased from distributable reserves – the amount transferred being the nominal value of the shares purchased.

Purchase from capital

Where shares are purchased out of capital, a special resolution is required, together with a statutory declaration of solvency by the directors. The auditors will need to supply evidence that they concur with this solvency statement. Additionally, a notice must be published in *The London Gazette* and a national newspaper.

Tax treatment – distribution v capital treatment

Under general principles, any buy-back is treated as a distribution of profits and hence is subject to income tax. A tax credit of 1/9th of the dividend will be available in the usual way, as for any other dividend.

Qualifying conditions for capital treatment – TA 1988, s. 219

TA 1988, s. 219 lays down all conditions required to be fulfilled if a payment made by an unquoted trading company on the purchase of its own shares is not to be treated as a distribution, but rather as a capital gains tax disposal by the shareholder. These can be briefly summarised as follows:

- (a) the company must be an unquoted trading company or the holding company of a trading group;
- (b) the purchase is made wholly or mainly for the purpose of benefiting the company's trade;
- (c) the transaction does not form part of a scheme of arrangement of which one of the main purposes is the avoidance of tax;
- (d) the vendor of the shares must be UK-resident and ordinarily resident in the year of sale and must have held the shares for five years (three years if they were inherited);
- (e) the vendor's interest in the company must be 'substantially reduced'. The holding in the company after repurchase should not be more than 75% of the holding before repurchase;
- (f) the vendor must not retain an interest of 30% or more in the company's issued share capital, ie, he must not be connected with the company as defined in s. 221 and s. 223.

Where these conditions are satisfied, the payment by the company is not treated as a distribution but is treated as consideration for the disposal of the shares and hence subject to capital gains tax. Although no claim is required if all the relevant conditions are satisfied, an advance clearance application to HMRC is available and is advisable (see later).

The share repurchase must be for the benefit of the trade of a trading company, and this often means that the whole of the shareholding must be sold. However, HMRC accept that a small sentimental holding may be retained. The retirement of an individual shareholder/director is usually accepted as being for the benefit of the trade. Indeed, any directorship would need to be resigned. Further coverage of this requirement is given in SP2/82.

Phased buy-back

In some circumstances a phased buy-back may be appropriate. This would ensure

that the company would agree to buy back the shares in successive stages. This would be conditional on future distributable profits and cash being available to fund the later stages of the buy-back.

If capital gains tax treatment is required, the buy-back programme must pass the substantial reduction test after each buy-in of shares. After the company buys in each tranche of shares, the shareholder's remaining interest must not exceed 75% of his pre-buy-in interest. This test must be satisfied after each buy-in, and HMRC will expect to see an agreed purchase programme in order that each buy-in can satisfy the benefit-of-trade test.

There must be sufficient distributable reserves at the time of the buy-back, and payment must be made on completion. The company may therefore need to ensure that borrowings are in place if insufficient cash is available.

An important point to note is that an unconditional contract will crystallise the CGT disposal at the date of the contract, although the proceeds will be phased. The documentation will need to be carefully drafted to obtain the desired result.

Multiple completion dates

In certain circumstances a multiple completion route may be desirable. This would be a binding contract, although payment is made over a period of time.

Multiple completion involves the shareholder contracting to sell his shares back to the company, but with the legal completion subsequently taking place over a period of time. The shareholder loses beneficial ownership on exchange and receives consideration at each planned completion date. By giving up his beneficial interest, the substantial reduction test referred to earlier does not apply.

On the downside, the shareholder would no longer be entitled to dividends or be able to exercise any voting rights over the shares. Being unconditional, the CGT liability crystallises at the date of the contract, not at the various completion dates. This would mean certainty about the tax rate and happily the 22 June 2010 emergency Budget has now confirmed the continuing availability of the 10% tax rate where a gain qualifies for entrepreneur's relief provided, of course,

that all the relevant conditions for that relief are satisfied.

Revenue clearance procedure TA 1988, s. 225

As mentioned earlier, it would be advisable to apply to HMRC for advance clearance as to the treatment of any payment to be made for a buy-back (ie, whether it will fall to be treated as a distribution or capital payment).

The application must be made in writing and must give full particulars of the transaction proposed. HMRC then have 30 days to either request further particulars or give their decision on the application. Applications are dealt with by HMRC's Clearance and Counteraction Team at 22 Kingsway, London WC3B 6NR.

Payment made under a buy-back arrangement, qualifying for CGT treatment, may be treated as being subject to an income tax charge under the transactions in securities legislation *ITA 2007*, s. 682-713. It would therefore be sensible to apply for clearance under that legislation, on the basis of its being a bone fide commercial transaction entered into by the company, at the same time.

HMRC have indicated that the price agreed for the shares would not normally affect its decision as to whether or not to give clearance: the decision would be made on the assumption that the price was a proper one.

Finally, the company must forward details of the buy-back to HMRC within 60 days of the transaction if capital treatment applies.

Summary

With the continuing availability of entrepreneur's relief, now confirmed by chancellor George Osborne, giving an effective tax rate as little as 10%, there will be very few instances where the vendor prefers a distribution route. Indeed the Budget has announced an increase in lifetime gains qualifying for entrepreneur's relief of up to £5m.

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