

Company purchase of own shares

(Lecture P1188 – 11.24 minutes)

Companies can purchase their own shares but only if they meet the company law requirements.

The following are the broad company law requirements for a purchase of own shares to be lawful although any question of legality should be checked with an appropriate corporate lawyer:

- the articles must not include any restriction or prohibition to the purchase occurring;
- the shares must be fully paid up;
- the shares must be paid for on purchase unless it is taking place for the purposes of an employees' share scheme in which case it can be paid in instalments;
- the purchase must be made out of the distributable reserves although there are some cases where it can be paid out of capital (and if the amount paid is less than the lower of £15,000 and the value of 5% of the company's ordinary share capital they do not have to identify availability of distributable reserves);
- the purchase must be authorised by an ordinary resolution of the company.

Any breach of company law means the purchase is unlawful meaning the vendor continues to be the beneficial owner of the shares and is holding the proceeds on constructive trust for the company. The money, if not repaid, would be treated as a loan subject to the loans to participators rules and subject to tax under s455 CTA2010. HMRC have, in the past, tried to argue that this money should be treated as an income distribution but this has been rejected by the First Tier Tribunal.

Tax treatment

A payment in excess of the amount paid on subscription is an income distribution. This is also a disposal for capital gains purposes but any proceeds treated as income would be excluded from the capital gains computation.

For a person who has subscribed for the shares that are being repurchased, this should mean that no gain or loss arises for capital gains purposes but the same may not be true if the capital gains tax base cost is other than the subscription price – for example where shares have been bought or inherited. Any loss arising is not a 'clogged loss' which would restrict the future usage as the company has not made an acquisition of the shares – they have simply been cancelled.

For corporate shareholders, the distribution would normally be exempt for corporation tax on income purposes so will automatically be treated as capital. The substantial shareholdings exempt could apply to this gain if all relevant conditions are met.

It is possible for the distribution to be treated as a capital distribution, and therefore subject to capital gains tax where certain conditions are met. This only applies to an unquoted company which is either a trading company or holding company of a trading group.

It is important to note that the definition of trading company is a company whose business which is wholly or mainly the carrying on of a trade or trades so not such a high bar as exists for entrepreneurs' relief and other capital reliefs.

The conditions are outlined in the paragraphs below.

Ownership period

At the date of purchase of the shares, the owner must have owned the shares for five years. This is reduced to three years only if the owner became entitled to the shares on the death of the previous owner (through their will or under intestacy) and the period of ownership can include the deceased owner's period of ownership. If the shares are sold by the personal representatives, they would also be able to utilise the deceased's ownership period as would a spouse or civil partner who is transferred shares during lifetime as long as the spouse or civil partners are living together both when the shares are transferred and when the shares are repurchased.

Where a vendor has made more than one acquisition of shares, the shares sold are identified with those that give the longest period of ownership. Where share reorganisations take place, then the holding period looks back through the reconstruction.

Residency

The vendor must be resident in the UK.

Benefit to the trade

The repurchase will be capital in nature if it is for the benefit of a trade or it is to provide funds to meet a liability to IHT charged on death. The latter is fairly self-explanatory.

What is meant when we say that it must be for the benefit of the trade? This is a subjective test to determine the motive of the vendor. It is unlikely that it will be met where a significant stake is retained or where the vendor is to remain fully engaged in the business of the company. A clearance process exists.

The repurchase must not form part of a scheme or arrangement with a main purpose of enabling the vendor to participate in the company's profits without receiving a dividend or the avoidance of tax.

Substantially reducing interest

The vendor must substantially reduce their interest in the company. In determining if this has happened it is necessary to take the interests of associates into account.

The most common ways in which a person is associated with another person is if they are:

- spouses or civil partners living together;
- a person under the age of 18 and his parents;
- a person and a company with which he is connected.

A shareholder's interest is only substantially reduced if it satisfied the following two tests:

1. the percentage of the nominal value of the issued share capital owned is not more than 75% of the percentage owned before the transaction, not forgetting to take account of the fact that the issued share capital will be reduced
2. if the company distributed all its profits available for distribution the fraction that the vendor would be entitled to would be no more than 75% of what he would have been entitled to before the repurchase. This can cause problems where there are preference shares in place and a nominal £100 is used if no distributable reserves exist.

Connection

The vendor must not be connected to the company after the purchase. A person is connected with a company for these purposes if:

- he has more than 30% of the ordinary share capital, voting rights, rights to income or rights to capital taking into account all rights and powers of this associates and taking into account which he is can acquire at a future date.
- he has control of it, being the power to ensure that the affairs of a company are conducted with his wishes derived from holding shares or by any powers applied by company documents.

Clearance

The company can obtain clearance from HMRC that they are happy that the benefit to the trade test will be met. As with all clearances, they are only valid if all the relevant information is provided to HMRC. There is no right of appeal against rejection of a clearance application although it is normal for HMRC to explain why they are refusing to give clearance. It would be normal to apply for clearance under the transactions in securities provisions at the same time.

Returns

A return must be made within 60 days of the date of disposal to HMRC to inform the department that the transaction has taken place. HMRC have information powers in relation to these transactions in particular if no return is received.

Practical issues

There are certain things that cannot be overcome, such as not having held the shares for the requisite period of time. If there is not sufficient cash or distributable reserves, then it may be possible to undertake a phased purchase such that a single contract is undertaken with phased completion. There was a recent sign that HMRC were starting to look at these more closely but they seem to have relented slightly as long as there will be a substantial reduction at each purchase which means that the purchase will tend to need to be front-loaded.

Transactions in securities provisions

Reference is made above to the advisability of getting clearance under the Transactions in Securities provisions at the time that a purchase of own shares clearance is made. The following examples show how the legislation might work to the advantage of a taxpayer in a way that might mean that HMRC would attack it under the TiS provisions.

A company has £1 shares and there are 1m in issue to a single shareholder. The high level of capitalisation was due to the initial capital needs of the business and the fact that the bank would only lend to the shareholder personally rather than to the company. The company now has surplus cash in the bank and wishes to reduce the share capital.

New consideration in this case is the same as the CGT base cost. If the company buys back half of the shares for £500,000 then this is a simple return of capital by repayment of new consideration. There is no income distribution and the disposal value for CGT purposes is the same as the base cost so no capital gain arises either.

If the company decided to pay £750,000 to repurchase the shares, then there would be an income distribution of £250,000 as there is no hope that the capital gains rules can apply as it is a single shareholder. No capital gain arises as the disposal value is again the same as the base cost.

Let's change the scenario slightly. A company has 100 £1 shares in issue; those were issued to a single shareholder at par. We then have 3 £1 shares that were issued to three other individuals on conversion of loans of £100,000 (in each instance) so there is a total of 103 £1 shares but a share premium account of £299,997. The original shareholder buys the £1 shares from the other shareholders as they wish to remove themselves from the picture. He buys them at par.

At a later date, it is decided that the company is going to repurchase 53 shares from the only shareholder and is proposing to pay £154,420 that is the total 'new consideration' that has been paid for the shares. There is no income distribution on the face of it as the repayment equals the new consideration. However, the new consideration does not equal the capital gains base cost – this is only £103. It would appear that there is a capital gain arising of £154,367.

It is likely that HMRC would consider that this is caught by the TiS provisions – assuming that the company has the distributable reserves as the individual has got value out of the company which is not subject to income tax. You might be alright if there is a bona fide commercial reason.

A more complex example gives a scenario where it may not be immediately obvious there is an issue. Let us say a company (which we will call OldCo) is liquidated with a cash distribution to the shareholders of £2,046,148 plus the transfer of assets to another company (which we will call NewCo), with the value of those assets being £398,845. The consideration for the transfer is the issue of ordinary shares in NewCo. The OldCo shares had been acquired for an average cost of 2.534p per share. Tax was payable on the cash distribution (and there would have been a part disposal computation for capital gains purposes) and the share for share exchange provisions applied for the shares as it was treated as a corporate reconstruction. The shares in NewCo were denominated as 1p shares but a share premium was created as each share was actually valued at 5.13p per share.

Let us say that you have a client who had 937,152 shares in OldCo and this was replaced with an equal number of shares in NewCo. The acquisition cost of the shares in NewCo was 0.41338p per share carried through the various transactions. The company is proposing to purchase some of its shares for 4.5p per share that is less than the 'new consideration' treated as being paid so no income tax distribution occurs. However, again, as the capital gains base cost is less than that there is a capital gain arising on the difference between the 4.5p being paid and the base cost of 0.41338p per share. Once again, there is a risk of the TiS provisions applying if there are distributable reserves in the company.

Contributed by Ros Martin