

Planning a multiple completion share buy-back

(Lecture P1120 – 21.12 minutes)

Purchase of own shares - capital gains treatment

For individual sellers, the main conditions that must be satisfied to prevent the purchase of own shares ('POS') from being a distribution (subject to income tax rates) – and therefore falling within the capital gains tax ('CGT') regime are as follows:

- The 'purchasing' company must be an unquoted trading company or holding company or a trading group;
- The purchase must be for the benefit of the purchasing company's trade (or the trade of any of its 75% subsidiaries) (s1033 CTA 2010);

(SP2/82 outlines the various factors that HMRC uses to determine whether the benefit of trade test has been satisfied. These include the retirement of a controlling shareholder-director who wishes to make way for new management or buying out a disinterested or aggrieved shareholder.)

- To meet the 'trade benefit' test, HMRC expect the outgoing shareholder to sell all their shareholding (although retention of 5% 'sentimental' stake is permitted). If appropriate, the seller must also resign as a director;
- The seller must be UK resident in the relevant tax year (s1034 CTA 2010);
- The seller must have held the shares for at least five years (s.1035 CTA 2010). There are special provisions which 'look through' a prior CGT reorganisation, so that the 'new holding' is deemed to be acquired at the same time as their former shareholding for these purposes (s1035 (3) CTA 2010).

Entrepreneurs' relief issues for purchase of own share sales

Although the relevant 'qualifying period for entrepreneurs' relief ('ER') is just TWO years (one-year for pre-5 April 2019 POS deals) before the disposal, the seller must have owned the relevant shareholding for at least five years to bring themselves into the CGT regime.

Thus, the qualifying period of share ownership for a POS would normally be five years, although the strict ER conditions will also need to be satisfied in the year before the POS.

In this context, make sure that any resignation as a director occurs on or shortly after the POS, otherwise HMRC are likely to deny ER on the grounds that the 'director' condition had not been fulfilled throughout the one year leading up to the POS! (see case of *J K Moore v HMRC* [2016] UKFTT 115 (TC)).

Financing a purchase of own share and the use of 'multiple completion' structures

Financing a purchase of own shares is not always easy. Company law demands that the purchase price for the shares bought back by the company is paid immediately (S691 (2), Companies Act 2006). It is not therefore possible for a company to buy-back its own shares for a deferred consideration.

However, because of the (often) substantial sums involved for the POS consideration, many owner managers have used the 'multiple completion' mechanism. Broadly speaking, a multiple completion POS agreement involves the owner manager contracting to sell their shares back to the company, but with the legal completion of the buy-back subsequently taking place in tranches.

A multiple completion contract enables the company to finance the purchase price over a number of years out of its (surplus) trading cash flows. Provided it is properly structured and implemented, this mimics a 'deferred consideration' deal whilst remaining compliant with company law.

In carrying out multiple completion deals, tax advisers still place reliance on the (then) Inland Revenue ruling in 1989.

In a statement the Inland Revenue confirmed its agreement to a purchase of own shares being made in instalments, as reported in the ICAEW technical release 745 issued in April 1989. Para 10 (b) of the release states:

"They [the Inland Revenue] take the view that as the beneficial ownership of the shares is regarded as passed at the date of the contract, a disposal for capital gains tax purposes will have taken place by the vendor at that time notwithstanding payments at later dates."

Practical experience has also shown that HMRC has generally given purchase of own shares tax clearances under s1044, CTA 2010 for properly structured purchase of own shares multiple completion deals.

Hitherto, tax advisers and HMRC has accepted the following technical analysis for a multiple completion purchase of own shares:

- For CGT purposes, the disposal of the entire beneficial interest in the shareholding takes place at the date of the contract (s28, TCGA 1992). Importantly, this means that if the seller shareholder qualifies for the ('no distribution') 'CGT' treatment and also ER, the full amount of the purchase of own shares proceeds should attract the beneficial 10% rate.
- Under the multiple completion route, the selling-shareholder gives up their beneficial interest in the repurchased shares on entering into the contract and therefore the 'substantial reduction' test does not apply. Thus, the seller cannot subsequently take dividends or exercise voting rights over the shares. Thus, since the 'seller' loses beneficial ownership of all the shares on entering into the contract, the various 'connection' tests imposed by s1042 and s1062, CTA 2010 are not in point.

- However, HMRC has always insisted that it is not legally possible to give up voting rights via the POS contract. If a shareholder still legally holds the shares, HMRC consider that they are still able to exercise their voting rights at a company meeting. Assuming this view is correct, the selling shareholder would be 'connected' with the company under CTA 2010, s 1062(2)(c) where the voting rights on the 'non-completed' purchase of own shares exceed the 30% limit.

However, if this is likely to be a potential issue, HMRC also accept that the problem can be corrected by converting the relevant 'non-completed' element of the shares into a separate class of non-voting shares.

- The subsequent 'multiple completion' of the purchase of own shares of the remaining tranches of shares is simply a legal process and normally has no bearing for tax purposes.

Although there had been some anecdotal evidence in 2017 that HMRC had changed its view on the tax analysis of a multiple completion purchase of own shares – which may restrict the availability of entrepreneurs' relief – it appears this is no longer a concern. HMRC published an update to its CG manuals (CG 58655) on 11 December 2018 that dealt with some of the technical points relating to multiple completion purchase of own shares – the potential entrepreneurs' relief issue was not mentioned.

Multiple Completion Purchase of Own Shares Case Study – Ravi & Daughter Ltd

Ravi currently holds 75% of the issue share capital of Ravi & Daughter Ltd, which has a 100% trading subsidiary, Sunrise Ltd.

Ravi & Son Ltd was the vehicle used to buy-out Ravi's business 'partner' in 1998, so that it became the holding company of Sunrise Ltd. Ravi gifted his daughter a 25% shareholding in 2014.

He now wishes to hand-over the shares in Ravi & Daughter Ltd to his daughter, whilst taking out a reasonable value for his shares. Ravi has asked his advisers how this can be achieved in a tax efficient way.

His advisers have proposed a company purchase of own shares.

Ravi has indicated that he would be happy with (say) £3 million for his shares. Although this valuation probably 'undervalues' the company, it considers the affordability of the buy-back from the group's viewpoint.

The group has been recently been making trading pre-tax profits of around £800,000.

Structuring a multiple completion purchase of own shares

Given the cash flow constraints, Ravi (see 'case study' above) was advised to use the multiple completion route to buy-back his shares (as 'blessed' by HMRC – see ICEAW Technical Release 745). Broadly, this involves the seller contracting to sell their shares back to the company, but with the legal completion of the buy-back subsequently taking place in tranches.

Under the multiple completion route, Ravi would have to give up his beneficial interest in the repurchased shares on entering into the contract and therefore the 'substantial reduction' test does not apply. Thus, the seller cannot subsequently take dividends or exercise voting rights over the shares. However, for CGT purposes, the disposal of the entire beneficial interest in the shareholding takes place at the date of the contract (s 28 TCGA 1992).

Experience suggests that HMRC are normally prepared to grant tax clearances for multiple completion purchase of own shares cases. Multiple completion transactions are invariably implemented to ensure that the financing of the purchase of own shares is Companies Act compliant - there is no tax avoidance involved.

Contributed by Peter Rayney