

Purchase of own shares: multiple completion (Lecture B1323 – 30.15 minutes)

It will be recalled that CTA 2010 spells out numerous conditions which have to be satisfied in order for an own share purchase to qualify for CGT treatment in the hands of the exiting shareholder.

One of the more important requirements is that, immediately after the purchase, the vendor must not be 'connected with' the purchasing company or any other company within the same 51% group (S1042 CTA 2010).

For this purpose, 'connected with' means possessing, directly or indirectly, more than 30% of the company's:

- issued ordinary share capital; or
- total share and loan capital; or
- voting power (S1062 CTA 2010).

Interests held by 'associates' (e.g. a spouse, civil partner or minor child) have to be taken into account, but adult children and their parents, along with brothers and sisters, are not included as associates (Ss1059 – 1061 CTA 2010).

Note that, by virtue of S1063 CTA 2010, the term 'loan capital' is given an extended meaning such that an immediate loan back of all or part of the vendor's proceeds can be caught.

In addition, if the exiting shareholder still holds some shares after the own share purchase transaction, his proportionate interest in the company must be 'substantially reduced' (S1037 CTA 2010). 'Substantial' in this context means 25% or more. It is necessary to determine the vendor's interest in the company immediately prior to the share repurchase and, provided that it comes down by at least one-quarter, a substantial reduction is deemed to have taken place. Once again, interests held by associates have to be considered when measuring this reduction.

HMRC's view is that the company must pay for the shares which it buys back in cash and not in kind. The speaker has had experience many years ago of a situation where three shareholders were being bought out, partly for cash and partly by having a property transferred to them. HMRC argued, following submission of the clearance application, that there was no 'purchase' if the company did not use cash to pay for the shares.

They said:

'The word "purchase" in S690(1) Companies Act 2006 must in that context bear its primary legal meaning as being the correlative of "sale" and involving the acquisition of property for a price in money.'

The main implication is that, if a company purports to purchase its own shares but does not make payment in full and in cash at the time, it will not have effected a valid own share buy-back. Thus, the vendors retain legal title to their shares and the company, if close, will have incurred a S455 CTA 2010 tax charge until such time as the resulting debt is cancelled by a proper purchase. This situation is confirmed in Para CTM17505 of the Company Taxation Manual.

It has been suggested that the decision in *BDG Roof-Bond Ltd v Douglas* (2000) is authority for the proposition that a purchase of own shares can be made by a payment in kind as well as in cash. Park J stated that he did not think the word 'payment' in the context of company law to be limited to payment in money. It would appear that HMRC have yet to catch up with this development!

A related point, which is particularly relevant in the current economic climate, is where a company wishes to buy out a shareholder but lacks the necessary funds to do so.

The obvious solution to resolve this cash flow constraint might be for the vendor to lend all or part of the share payment back to the company. Unfortunately, this arrangement will nearly always fall foul of the 30% 'no continuing connection' test referred to above.

A useful solution to this dilemma has been for the company to enter into a single unconditional sale contract with the vendor and for legal completion of the buy-back to take place on a series of future dates in respect of separate tranches of shares within the agreement. This is known as a multiple completion contract. The effect of the procedure is that the 'substantial reduction' test only has to be considered once, i.e. at the date of the contract. The vendor has to give up his beneficial interest in the repurchased shares on entering into the contract and so he could not subsequently take dividends or exercise voting rights over the shares. He must also satisfy the 'no continuing connection' test. However, it should be emphasised that completion of the contract in stages does not create a debt for this purpose.

For CGT purposes, the disposal of the entire beneficial interest in the shareholding takes place at the date of the contract. Therefore, the vendor should always ensure that he has sufficient cash resources with which to meet the full tax liability by the 31 January following the tax year in which the multiple completion contract is made. In ICAEW TR745 (which was published in April 1989), HMRC accepted that multiple completion contracts represented valid tax planning arrangements provided, of course, that beneficial ownership passed at the contract date.

More recently, a new difficulty arose in that HMRC expressed an opinion that company law still entitled the vendor to vote on his shares, notwithstanding that he had contracted to sell them and had lost beneficial ownership. If this view is correct (which is by no means certain), a vendor would be connected with his company under S1062(2)(c) CTA 2010 if the voting rights on what might be called the 'non-completed' shares exceeded the 30% limit. However, it did not take advisers long to find a way around this predicament: the problem can be resolved by converting the relevant holding into a separate class of non-voting shares.

This potential trap is unfortunately not the end of the story. In the last few months, HMRC have started to argue that the word 'possesses' in S1062(2) CTA 2010 refers to legal, as opposed to beneficial, ownership. When shares are sold by way of a multiple completion contract, the vendor will lose beneficial ownership of all his shares on the date of the contract, but he will retain legal ownership of the shares until completion. This, HMRC say, 'is the case even if those remaining shares are converted to so-called deferred shares with no voting or economic rights in the company on completion of the first tranche (of the deal)'. Therefore, as long as the vendor remains the legal owner of sufficient 'non-completed' shares in excess of the 30% limit, he is still connected with the company under S1062(2)(a) CTA 2010 and cannot qualify for CGT treatment.

HMRC continue:

‘In the past, (we) may have issued clearances under S1044 CTA 2010 where the connection test might not have been met due to retained legal ownership of the shares. For the avoidance of doubt, HMRC will not treat such clearances as void purely on the basis of retained legal ownership of the shares. However, going forward, HMRC will apply the connection test as described above which may result in . . . applications being rejected.’

The Company Taxation Manual will be updated shortly to reflect HMRC’s latest interpretation.

In this context, one commentator has said:

‘We understand that this has been HMRC’s view for many years. For some reason, however, for the last several years this aspect has been overlooked such that clearances for capital treatment have been granted when, according to HMRC’s analysis, the technical conditions were not satisfied. HMRC have, however, recently “rediscovered” their original analysis and are now enforcing it so that multiple completion transactions where a shareholder retains legal ownership of more than 30% of the ordinary share capital of a company will not be granted clearance.’

What is now to be done where a company cannot afford to make payment for the shares in one go.

The CIOT and other professional bodies believe that there are technical arguments which will show HMRC’s new approach to be mistaken. These are in the process of being developed and will be presented to the tax authorities in due course.

In the meantime, the simplest way out is to structure the own share purchase tranches so that the vendor initially sells rather more shares in the first tranche which will result in the taxpayer limiting his holding to 30% or less. See the illustration below.

Another option is for the legal ownership of the shares in question to be transferred to a nominee. By virtue of S60(1) TCGA 1992, this would involve the company as the beneficial owner of the shares, and not the shareholder.

Illustration

RST Services Ltd is an unlisted company which has been trading since 1972. It is currently owned by three unrelated shareholder directors as detailed below:

<u>Shareholder directors</u>	<u>Number of £1 ordinary shares</u>	<u>Holding</u>
Robert	45,000	45%
Simon	30,000	30%
Thomas	25,000	25%

In view of his approaching 75th birthday, Robert has decided to retire from RST Services Ltd, leaving his younger colleagues in control of the business.

Simon and Thomas have an option to buy Robert's shares, but they all agree that it would be more tax-efficient for the company to purchase Robert's holding of 45,000 ordinary shares at an agreed fair value of £1,800,000, being £40 per share. These shares will then be cancelled. In order to avoid any adverse impact which the deal might otherwise have on RST Services Ltd's working capital requirements, the company will buy back Robert's shares under a multiple completion contract which will be structured as follows:

<u>Proposed completion dates</u>	<u>Purchase</u>
	<u>Number of shares</u> <u>Consideration</u>
1 August 2022	15,000 £600,000
1 August 2023	15,000 £600,000
1 August 2024	15,000 £600,000

Under HMRC's current interpretation of the 30% 'no continuing connection' test, Robert will possess (i.e. be the legal owner of) more than 35% of RST Services Ltd's ordinary share capital immediately after the own share buy-back contract is entered into (and the purchase of the first tranche is completed).

At this stage, Robert's holding comprises $45,000 - 15,000 = 30,000$ shares and the company's total ordinary share capital stands at $30,000 + 30,000 + 25,000 = 85,000$ shares.

Thus:

$$\frac{30,000}{85,000} \times 100 = 35.294\%$$

Robert possesses more than 30% of RST Services Ltd's ordinary share capital and he is therefore connected with the company under S1062(2) CTA 2010. He will not be eligible for CGT treatment. He has also not met the 'substantial reduction' test.

However, it may be possible to modify the own share purchase agreement by increasing the amount of 'first tranche' shares purchased by the company so that Robert is left with 30% or less of the various parameters. Thus, if, for example, Robert was to sell 22,500 shares back to RST Services Ltd as an initial tranche, he would satisfy the 'no continuing connection' test. Thus:

$$\frac{22,500}{77,500} \times 100 = 29.032\%$$

And he has clearly effected a 25% substantial reduction.

Contributed by Robert Jamieson