

Reducing capital to create distributable reserves (Lecture B1378 – 17.17 minutes)

Family and owner-managed companies can more readily reduce their share capital in a way which was not possible prior to the enactment of Companies Act 2006. The previous company law legislation stated that a company might, if authorised by its Articles of Association, reduce its share capital. The key requirements were then:

- a special resolution to this effect had to be passed by the company's members; and
- the reduction needed to be confirmed by the Court (which was an expensive exercise).

By virtue of Ss.641 – 653 Companies Act 2006 (which came into force on 1 October 2009), a private company is now able to reduce its share capital by using a solvency statement procedure as an easier and cheaper alternative to obtaining Court approval. The passing of a special resolution is still a prerequisite, but the necessity for prior authorisation in the Articles of Association has not been retained by Companies Act 2006.

These capital reduction rules are used in a variety of circumstances to assist private companies to, for example, create distributable reserves (often by removing a debit balance on the company's profit and loss account) which can then enable a legal dividend to be paid.

Although many private companies have small amounts of issued share capital, it is important to remember the ability to reduce share capital includes the reduction or elimination of a share premium account and/or capital redemption reserves. In addition, as one commentator has pointed out:

'While it is not permissible to apply a property revaluation reserve as part of a capital reduction exercise, the same result can be achieved by first using the revaluation reserve to create fully paid-up bonus shares equal to the capitalised amount. Having created additional share capital, this can then be reduced in accordance with the Companies Act 2006 provisions.'

Briefly, the legal procedure for private companies involves the following:

- Within the 15-day period prior to the passing of the special resolution, the directors must support the capital reduction by providing a solvency statement which complies with S643 Companies Act 2006.
- This statement, which must be approved by each director, has to confirm that:
 - there is no ground on which the company could be found to be unable to pay its debts; and
 - any winding up of the company within the next 12 months would be a solvent liquidation.
- After the special resolution has been passed, the company must, within the next 15 days, deliver to the Registrar of Companies:
 - a copy of the special resolution;
 - a copy of the solvency statement; and

- a statement of capital setting out the information specified in S644(2) Companies Act 2006.

In practice, one of the more common uses of this capital reduction process is to eradicate a profit and loss account deficit. The company simply reduces its share capital (with each member's interest contracting on a *pro rata* basis). A corresponding credit is made to the company's distributable reserves. This then forms part of the company's distributable profits as confirmed by The Companies (Reduction Of Share Capital) Order 2008 (SI 2008/1915).

HMRC's view is that dividends paid out of profits created in this way represent normal income distributions for tax purposes under s.1027A CTA 2010 – see Para CTM15440 of the Company Taxation Manual. This is the case despite the fact that the distribution originally arose from a share capital reduction.

Where a company's share capital is reduced by a transfer to distributable profits, the shareholders' equity stake in the company should not alter. Since no payment is involved, the share capital reduction will fall within the share reorganisation rules in s.126 TCGA 1992. The elimination of part of the shares does not therefore involve a CGT disposal (s.127 TCGA 1992).

Example 1

An extract from the balance sheet of Peter Paul & Mary (Music Publishers) Ltd as at 30 June 2023 shows the following:

	£
Share capital – 3,000 ordinary shares of £1 each	3,000
Share premium account	180,000
Profit and loss account	<u>(66,000)</u>
	<u>117,000</u>

Peter, Paul and Mary have identical shareholdings and are the company's only directors. The company was adversely affected by the COVID pandemic – hence the debit balance on the company's profit and loss account which has only recently come into being.

The shareholders need to have dividends of £30,000 each in 2023/24, but unfortunately Peter Paul & Mary (Music Publishers) Ltd has no distributable reserves. However, the directors have been told by their tax adviser that they can create the necessary reserves by reducing the company's share capital under s.641 Companies Act 2006.

They would like to create reserves of £105,000 and so a special resolution is passed to eliminate £171,000 from the share premium account.

After the reduction, the shareholders' funds in the balance sheet are made up as follows:

	£
Share capital – 3,000 ordinary shares of £1 each	3,000
Share premium account (180,000 – 171,000)	9,000
Profit and loss account (171,000 – 66,000)	<u>105,000</u>
	<u>117,000</u>

Peter Paul & Mary (Music Publishers) Ltd now has sufficient reserves to declare dividends totalling £90,000 for the three shareholders. These dividends will be subject to income tax as normal.

Contributed by Robert Jamieson