

Purchase of own shares – Practical issues (Lecture P1301 – 14.43 minutes)

Purchase of own shares is a useful tax planning tool for owner managed businesses where the company has cash reserves to be able to buy shares back from a shareholder.

The buy-back will be treated as an income distribution likely to be taxed at 32.5% to 38.1% unless the conditions for capital treatment are met.

Example

Consider a family company worth £2 million with significant cash reserves. Will and Grace own 30 shares each with their older children Josh and Emily each owning 20. All four are directors and work full time in the business.

Will is older than Grace and would like to retire, while Grace is happy to continue working in the business but may take more holidays going forward.

A purchase of own shares is worth consideration. The company has the cash reserves to pay Will £600,000 but he is keen to retain a small interest in the company; say 5% for sentimental reasons. He has therefore suggested £500,000 for 25 of his shares. As part of the buy-back, he will return 25 of his shares to the company and these will then be formally cancelled. He would also like to remain as a director of the company.

Capital treatment

Where the capital treatment applies, a gain will crystallise and Will is likely to qualify for 10% Business Asset Disposal Relief, often making this the preferred option.

However, the capital treatment only applies where certain conditions are met. HMRC clearance is available here and should always be sought as the difference between the capital and income treatment is significant.

HMRC has published new guidance that covers straightforward situations when an unquoted trading company purchases its own shares and explains:

- the conditions (A or B) that must be met before the payment can be treated consideration for the disposal of shares and so subject to CGT rather than as a distribution liable to income tax;
- how a company can make a clearance application in connection with the purchase of own shares legislation.

Condition A

Under this condition, the purchase of own shares must be made wholly or mainly to benefit an unquoted trading company's trade. Retirement can qualify as benefiting the trade but staying on as a director can be a problem. It is advisable that the shareholder/ director resigns his directorship.

Further:

- the seller must be a UK resident at the time the purchase is made;
- the seller must have owned the shares at least five years ending with the date of the purchase or three years if the seller acquired the shares under the will or intestacy of a former shareholder (see below);
- the shareholding interests of the seller and their associates in the company (and group, if appropriate) must be substantially reduced (See below)
- the seller and their associates must not be connected to the company after the purchase takes place; and
- the purchase must not form part of a scheme or arrangement where one of the main purposes is to enable the seller to participate in the profits of the company without receiving a dividend and/or avoiding tax.

Condition B

Here the purchase must be in connection settling an Inheritance Tax liability. This means that if the payment made is used by the seller to pay Inheritance Tax liability, the payment may not be treated as a distribution provided that:

- substantially the whole of the purchase money is applied by the seller in paying the tax liability;
- the tax was charged on a death;
- the payment received from the company is applied in the discharge of the tax liability within two years of the death;
- the tax paid could not have been paid without undue hardship;
- The payment by the company must be received by the person who is liable for the Inheritance Tax.

Owning the shares for at least five years

Where the seller has made more than one acquisition of shares of the same class that are being redeemed, repaid or sold to the company, earlier acquisitions of shares are taken into account before later acquisitions. However earlier disposals are treated as being made on a last in, first out basis. This gives the seller the longest possible period of ownership for this purpose.

If at any time during the five-year period, the shares were transferred between spouses or civil partners living together at the date of transfer, then the periods of ownership of both spouses or civil partners are aggregated.

Substantial reduction test

The substantial reduction in the seller's interest as a shareholder in the company is considered in two ways, by considering:

- the issued share capital;
- entitlement to profits.

Reduction in seller's shareholding

To test whether there's been a reduction in the seller's shareholding, the relevant proportion immediately after the sale is compared with that immediately before the purchase.

The relevant proportion is the nominal value of the shares owned by the seller divided by the issued share capital of the company. If the seller's interest immediately after the purchase is not more than 75% of their interest immediately before the purchase, it has been substantially reduced.

The calculation must take into account the fact that the number of shares in issue will have decreased after the purchase as these shares are normally cancelled by the company.

Example

A Ltd has an issued share capital of £1,000 comprising of 1,000 £1 shares. You hold 400 of those shares and sell 250 shares to the company.

This means that immediately before the sale you hold 40% of the issued share capital:

- the nominal value of your shares is 400
- the total issued share capital is 1,000

After the sale you hold 20% of the issued share capital:

- the nominal value of your shares is 150 (400 – 250)
- the total issued share capital is 750 (1000 – 250)

A 75% reduction in your shareholding would leave you with 30% of the issued share capital (75% of 40% is 30%).

After the sale you hold 20% of the issued share capital so your shareholding interest has reduced to not more than 75% of the original holding and the substantial reduction test has been met.

Reduction in seller's entitlement to share in the profits

Broadly the seller's interest as a shareholder is taken to be substantially reduced if the company were to distribute all its profits available for distribution and the seller's entitlement to a share of those profits (expressed as a fraction of the total of those profits) immediately after the purchase would be not more than 75% of the corresponding fraction immediately before the purchase.

Associates and the substantial reduction test

When applying the calculation, the interests of any persons associated with the seller are also relevant.

Associates are:

- spouses or civil partners who live together;
- children aged under 18 and their parents;
- a person connected with a company is an associate of that company and any company it controls (e.g. You are the sole shareholder of X Ltd. X Ltd has a 100% subsidiary, Y Ltd. You are an associate of both X Ltd and Y Ltd;
- a person accustomed to acting on the directions of another person in relation to the affairs of a company (both are associates of each other in relation to that company);
- companies are associated with one another if they are under the control of the same person (e.g. You are the sole shareholder of C Ltd and D Ltd. This means C Ltd is an associate of D Ltd and vice versa;

Returning to our first example with Will and Grace. Before the buy-back the couple held 60% (60/100) and after the buy-back they hold 46.67% (35/75) as 25 shares would have been cancelled as a result of the buyback. For the 75% test to be satisfied the interest must be reduced to below 45% (75% of 60%) and so, in this example, the test is breached. Note that if all his shares had been bought back by the company the company would still have 70 shares in issue with Grace holding 30 so the relevant percentage would have been 42.8% (30/70). The test would have been satisfied but this was not the case here.

Seller connected with the purchasing company immediately after the purchase

The seller must not be connected with the company, or any company in the group, following the purchase of shares. A person will be treated as connected with the company if they:

- possess, or are entitled to acquire, more than 30% of the issued ordinary share capital, loan capital or voting power, or
- are entitled to receive more than 30% of the assets on a winding up of the company.

In applying the connection test, the interests of the seller's associates are aggregated with the seller's own. In our example, even if Will sold all of his shares back to the company, Grace would still own 30 of the 70 shares in issue, which is more than 30% and so this test is breached.

(If the loan capital of the company was acquired in the ordinary course of a business carried on by the shareholder which includes the lending of money and the shareholder takes no part in the

management or conduct of the company, his interest in the loan capital is disregarded in applying the 30% test.)

Solution for Will and Grace

In our example, even if Will resigned his directorship and sold back all of his shares, the buyback of shares would not satisfy the capital treatment conditions and he would be taxed under the income distribution method, which is far from ideal. To solve the problem we could discuss with the couple whether Grace would consider retiring as well or maybe gifting some of her shares to her children? Alternatively, it may be worth delaying the buyback until such time as Grace is also ready to retire. In the meantime, Will could just reduce the hours that he worked.

Making a clearance application

A company wishing to make a purchase of its own shares can get advance confirmation from HMRC that the distribution arising will be an exempt distribution. Clearance applications are the responsibility of the Clearance and Counteraction Team.

Email applications

HMRC's team are able to process an application more efficiently if companies email their application to reconstructions@hmrc.gov.uk. Companies should not include attachments larger than 3MB or self-extracting zip files as HMRC's software will block them.

Postal applications

HMRC states that it accepts no responsibility for applications lost in transit prior to receipt. Companies should use a secure delivery method such as Royal Mail recorded delivery sending their application to:

BAI Clearance
HMRC
BX9 1JL

The guidance concludes with checklists containing the information HMRC needs to reach a decision.

<https://www.gov.uk/guidance/clearance-applications-and-exempt-distribution-when-a-company-purchases-its-own-shares>