CHAPTER 34

PURCHASE OF OWN SHARES

34.1 Introduction

Sometimes a company may purchase its own shares – this is often called a share buy back. The company purchases its own shares and the shares are normally then cancelled.

This route may be the only way a shareholder can get the capital they originally invested in the company back when they wish to "sell" their shares. There may be no willing external purchasers for the shares, or perhaps it is a family company and the family want to keep the shares within family ownership but cannot afford to buy the shares back from the shareholder themselves.

Depending on the circumstances there are two possible tax treatments of the share disposal by the individual – the income treatment or the capital treatment.

Under the **income treatment,** the receipt by the individual is treated as a **dividend** and taxed at either 10%, 32.5% or 42.5%, with the benefit of the dividend tax credit.

Under the **capital treatment,** the disposal gives rise to a **chargeable gain** which is taxable on individuals at 18% or 28% and may qualify for entrepreneurs' relief.

Where shares are bought back from a **corporate shareholder**, the **capital treatment** always applies.

There are strict legal requirements in the Companies Act regarding the purchase by a company of its own shares. Under the Companies Act the shares must be paid for when purchased and HMRC's Tax Bulletin 21 (Feb 1996) states that the share must be paid for with money.

34.2 Income treatment

Payments by companies in respect of share buy backs from individuals are usually treated as income distributions i.e. dividends. This is the normal treatment that applies to the purchase of own shares.

The **net dividend** will be the **amount received** on the share buy back **less** the original **subscription price** of those shares. The subscription price is normally the same as the nominal value of the shares.

In addition there is a capital gains computation on the disposal of the shares. The **sale proceeds for capital gains tax purposes is the original subscription price** of the shares, which is the price at which the company issued the shares to the original shareholders.

Consequently, if the shareholder was the original subscriber of the shares, this computation will result in a capital gain of nil. If the individual was not the original subscriber, a capital loss will arise.

	£		£
Amount received on share buy back	X	Original subscription price	X
Less: original subscription price	(X)	Less: actual cost	(X)
Net dividend received	**X**	**Chargeable gain/loss**	**Nil/(X)**

Illustration 1

Alicia subscribed for 900 £5 ordinary shares in Raf Ltd some years ago. Raf Ltd is now going to buy back all of Alicia's shares for £7 per share.

The net dividend received per share will be £2, being the £7 received on the share buy back less the £5 original subscription price.

As Alicia has 900 shares that are to be bought back then she will be receiving a net dividend of 900 x £2 = £1,800. This will be grossed up to 1,800 x 100/90 = £2,000. On her tax return if she is a higher rate taxpayer then tax will be payable at 32.5% and a tax credit of £200 will be available to set against this.

Alicia has also disposed of her shares in Raf Ltd. If she was the original subscriber her CGT calculation will show:

	£
Sale proceeds = original subscription price = 900 x £5	4,500
Less: actual cost = 900 x £5	(4,500)
Chargeable gain	Nil

If Alicia was not the original subscriber, but bought her shares, for say £5.50 each, her CGT calculation will show:

	£
Sale proceeds = original subscription price = 900 x £5	4,500
Less: actual cost = 900 x £5.50	(4,950)
Capital loss	(450)

Example 1

Carolyn has 400 £1 ordinary shares in Miguel Ltd. She bought the shares from Margo for £3 a share some time ago. The company is now buying the shares back from Carolyn at a price of £5 per share.

You are required to calculate the dividend assessable on Carolyn and her chargeable gain or capital loss as a result of the share buy back.

34.3 Capital treatment

Provided certain conditions are met the buy back will not be treated as a distribution, rather the shareholder will be treated as receiving a capital sum on disposal of the shares equal to the amount paid by the company. This gives rise to just one calculation – a **normal capital gains** computation.

This treatment only applies to purchases of own shares by **unquoted trading companies** that are not 51% subsidiaries of a quoted company, or to purchases of own shares by unquoted holding companies of a trading group.

The repurchase must be made either:

(i) to wholly or mainly **benefit the trade** carried on by the company (or a 75% subsidiary) and is not part of a scheme the main purpose of which is the avoidance of tax, and

CTA 2010, s.1033

a) the vendor must be **resident and ordinarily resident** in the UK at the time of the purchase,

b) the vendor must have owned the shares for at least **5 years** (3 years if acquired as a result of a death, and the ownership period of the deceased is included). Holding periods of a spouse can be counted.

c) there must be a **substantial reduction** in the vendor's shareholding (see below), and

d) following the buy back the vendor must **not be connected** with the company (see below).

Or

(ii) The whole, or substantially the whole, of the payment is applied by the person to whom it is made in discharging a liability of his for IHT arising on the death of a person within the period of two years after the death.

Illustration 2

Antonio owns 1,000 out of 10,000 £1 ordinary shares in Valencia Ltd, a trading company. Antonio has owned these shares for the last 10 years, during which time he has been a full time director. The shares were issued to Antonio at par.

Valencia Ltd is going to buy back these shares for £10 each.
We will assume that the purchase is for the benefit of the company's trade and that Antonio is resident and ordinarily resident in the UK. The other conditions for the capital treatment are satisfied, so the purchase will be treated as a capital disposal by Antonio.

A normal capital gains computation will apply:

		£
Sale proceeds	1,000 x £10	10,000
Less: cost	1,000 x £1	(1,000)
Gain		9,000

In this case Antonio is also a director and has owned at least 5% of the shares for a year prior to the date of disposal so entrepreneurs' relief is available so the gain will be taxed at 10%.

34.4 The substantial reduction test

This test requires **a 25% reduction** in the vendor's interest in the company when we compare his holdings pre and post the buy back.

CTA 2010, s.1037

The test has two parts to it. The first part of this test looks at the 'nominal value' of the vendor's shareholding and the second part of this test looks at his interest in 'distributable profits'. In both cases, the vendor's interest must be reduced by 25% or more.

The **'nominal value' test** is the one which is most commonly tested in the exams.

We compare the total nominal value of the shares owned by the vendor immediately before the buy back, expressed as a fraction of the issued share capital of the company at that time, with the corresponding fraction immediately after the share buy back.

The fraction after the buy back must not exceed 75% of the fraction before the buy back.

Remember that the number of shares in issue will also have decreased after the buy back as these shares are normally cancelled by the company.

Illustration 3

Dave holds 2,500 £1 ordinary shares in Guti Ltd. The company has 15,000 £1 ordinary shares in issue and is going to buy back half of Dave's shares and 1,000 shares from Jim, another shareholder.

Before the buy back Dave has $\frac{2500}{15000}$ = 16.7% of the company

After the buy back he will have $\frac{2{,}500 - 1{,}250}{15{,}000 - (1{,}250 + 1{,}000)} = \frac{1{,}250}{12{,}750} = 9.8\%$

Thus Dave's interest has fallen from 16.7% to 9.8%. Is this reduction big enough?

He has reduced his interest by $\frac{16.7\% - 9.8\%}{16.7\%} = 41\%$

This reduction is at least 25% hence the reduction is big enough.

Alternatively we could ask is Dave's shareholding after the buy back less than 75% of 16.7%, his shareholding before the buy back?

Again the answer is yes because a 9.8% shareholding is less than 12.5% (75% x 16.7%).

The substantial reduction test has been met.

Note that a 50% reduction in Dave's shares only led to a 41% reduction in his interest in the company. This is because the number of shares in issue was also reduced.

The **distributable profits test** is borrowed from the Companies Act. We have to look at the vendor's interest in the profits available for distribution before and after the buy back. The vendor's interest in the distributable profits must also be reduced by 25% or more.

For the purposes of this test, the profits available for distribution before the buy back are the sum of:

- The distributable profits
- A statutory addition of £100

CTA 2010, s.1038(4)

- Dividends on fixed rate preference shares
- The proceeds used to buy back the shares which exceed the distributable profits immediately before the buy back (where applicable).

The profits available for distribution after the buy back are the sum of:

- The distributable profits left after the buy back (if any)
- A statutory addition of £100 *(CTA 2010, s.1038(4))*
- Dividends on fixed rate preference shares

Illustration 4

Let's say that Micro Ltd has distributable profits of £15,000. The company has 33,333 £1 ordinary shares in issue and £10,000 5% fixed rate preference shares.

Jackie owns 10,000 £1 ordinary shares and £3,000 5% fixed rate preference shares.

Micro Ltd is to buy back 6,000 of her £1 ordinary shares and £500 of her 5% fixed rate preference shares. The company will pay a total of £20,000 for these shares.

Thus we can see that Jackie holds 30% of the ordinary shares and 30% of the fixed rate preference shares.

Her interest in the shares will reduce from 30% to

$$\frac{13{,}000-6{,}500}{43{,}333-6{,}500} = \frac{6{,}500}{36{,}833} = 17.65\%$$

A reduction of $\frac{30 - 17.65}{30}$ = 41.17%

Therefore the nominal value part of the substantial reduction test is satisfied since Jackie's shareholding has decreased by at least 25%.

Next we need to determine whether or not Jackie's interest in the company's distributable profits has also decreased by at least 25%.

Micro Ltd's profits available for distribution before the buy back are:

	£
Distributable profits	15,000
Statutory addition	100
Preference dividend (£10,000 x 5%)	500
Excess of proceeds used to buy back shares over distributable profits (£20,000 - £15,000)	5,000
	20,600

Before the buy back Jackie's interest in the distributable profits is calculated as:

	£
Distributable profits (£15,000 x 30%)	4,500
Statutory addition (£100 x 30%)	30
Preference dividend (£3,000 x 5%)	150
Excess of proceeds used to buy back shares over distributable profits (£5,000 x 30%)	1,500
	6,180

$\frac{6{,}180}{20{,}600}$ = 30% interest in distributable profits before the buy back.

Micro Ltd then buys back some of Jackie's shares for £20,000. The company will have used all of its £15,000 distributable profits plus a further £5,000 from other reserves to buy back the shares.

The company will also now only have £9,500 5% fixed rate preference shares in issue.

Therefore, after the buy back, Micro Ltd's profits available for distribution are now:

	£
Statutory addition	100
Preference dividend (£9,500 x 5%)	475
	575

There are no distributable profits left after the buy back.

After the buy back Jackie's interest in the distributable profits is calculated as:

	£
Statutory addition (£100 x 4,000/27,333*)	15
Preference dividend (£2,500 x 5%)	125
	140

* Jackie's interest in the statutory addition is only based on the proportion of ordinary shares that she owns.

Jackie's share is $\frac{140}{575}$ = 24.35%

Jackie's interest has fallen from 30% to 24.35% which is a fall of:

$\frac{30 - 24.35}{30}$ = 18.83%

This is not a substantial reduction and hence the substantial reduction test is not satisfied.

34.5 The connection test

A person will be treated as connected with the company if they:

CTA 2010, s.1062

1) Possess, or are entitled to possess, more than 30% of the:

- Issued ordinary share capital, or
- Loan capital, or
- Voting power.

Or,

2) Are entitled to receive more than 30 % of the assets on a winding up of the company.

34.6 Treasury shares

FA 2003, s.195

A company is legally allowed to purchase its own shares without having to cancel them. Such shares are known as "treasury shares". Finance Act 2003 laid down the tax rules for the treatment of such shares.

Although the shares are not cancelled by the company, they will be treated as cancelled for tax purposes. The company will not be treated as becoming a member of itself.

The share capital of the company will be treated as reduced by the nominal value of the shares bought back.

Where the shares are later disposed of by the company, the company will be treated as having issued new shares.

If the consideration received on sale is less than the nominal value of the shares, the shares will be treated as having a nominal value equal to the amount of consideration received.

Where the consideration received on sale exceeds the nominal value of the shares, the shares will be treated as being issued at a premium.

This treatment does **not** apply if the amount **paid** for the repurchased shares is taken in to account in calculating the **trading profits** of the company.

Answer 1

Dividend:

	£
Amount received on share buy back 400 x £5	2,000
Less: original subscription price 400 x £1	(400)
Net dividend received	1,600

Gross dividend = $1600 \times \frac{100}{90}$ = £1,778

Capital gains tax:

	£
Sale proceeds = original subscription price = 400 x £1	400
Less: actual cost = 400 x £3	(1,200)
Capital loss	(800)