

Multiple attraction

SARA COHEN considers the single contract multiple completion route in relation to private company share buybacks.

There are many reasons why a company might wish to buy shares back from shareholders, e.g. to return excess cash to shareholders or to increase the earnings per share of the remaining shares.

In the case of private companies there will frequently be provisions in their articles of association which give them first call if a shareholder wishes to sell and which also allow them to buy shares back compulsorily from directors or employee shareholders who leave. Companies often wish to exercise those rights to control who holds their shares. In other cases, the shareholders may have fallen out or disagree as to how the business should be run and it is in everyone's best interests for the company to buy shares back from a dissenting shareholder.

The default position for tax purposes is that the proceeds of a share buyback over the capital element, generally the nominal value plus any premium paid at the time of subscription, are treated as if they were a distribution in the hands of the selling shareholder in the same way as a conventional dividend. In practice, after allowing for the one-ninth tax credit, this means an effective rate for 50% taxpayers of 36.1%.

Getting capital treatment

CTA 2010, s 1033 (formerly TA 1988, s 219) states that, provided certain conditions in that section and s 1034 to s 1043 (so far as applicable) are met, a payment made by a company for the purchase of its own shares is not a distribution for tax purposes, but a capital receipt in the hands of the seller.

Section 1044 provides for advance clearance to be sought from HMRC to confirm they are satisfied that s 1033 will apply. If HMRC give the clearance, the selling shareholder will pay capital gains tax on all the buyback proceeds, instead of income tax on the excess over the capital element. If the seller is entitled to entrepreneurs' relief, this means an effective rate of 10% on



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the first £10m of lifetime gains for disposals on or after 6 April 2011. Even if entrepreneurs' relief is not available, 50% taxpayers will pay capital gains tax at a maximum flat rate of 28% and the first £10,600 will be exempt to the extent that the annual exemption has not already been used.

Structuring a buyback

A buyback can be structured in different ways. These include:

- an upfront buyback of all the seller's shares;
- an upfront buyback of all the seller's shares followed by a loan back from the seller if the company's cash resources are limited;
- an upfront disposal of the seller's entire beneficial interest with completion taking place on successive dates (known as a 'multiple completion buyback').

There are several reasons why a company and a selling shareholder may wish to structure a buyback as a multiple completion buyback. For example:

- the company wishes to buy all the seller's shares but cannot afford to do so in a single transaction (and company law prohibits a company paying for its shares in instalments);
- the seller qualifies for entrepreneurs' relief at the date of the contract, but will not afterwards as he will cease to be a director or employee; and/or
- a series of smaller buybacks would not satisfy the requirements for capital treatment summarised below, particularly the trade benefit and mathematical substantial reduction and connection tests.

The purpose of this article is to look more closely at multiple completion buybacks. We have previously succeeded in obtaining clearance from HMRC for buybacks on this basis, but they are

KEY POINTS

- Multiple buybacks can help spread the cost.
- Obtaining clearance from HMRC.
- Drafting the buyback agreement.
- Restrictions on unquoted companies.
- Who owns the shares?

relatively uncommon. Furthermore, in our experience, not all the staff in the clearance and counteraction team in HMRC's anti-avoidance unit are familiar with multiple completion buybacks and may challenge the arrangement. A more detailed company law and tax analysis is therefore set out below.

Capital treatment

Before looking more closely at the particular technical issues relating to multiple completion buybacks, it is worth summarising the tests in CTA 2010, s 1034 to s 1043.

Trading and unquoted status tests

The company must be an unquoted trading company or the unquoted holding company of a trading group (s 1033(1)(a)). An unquoted company for this purpose includes one whose shares are dealt in on AIM, but in practice it is likely to be the smaller companies with few shareholders which seek to effect a buyback in this way.

Trade benefit test

The buyback must be made wholly or mainly for the purpose of benefiting a trade carried on by the company or a 75% subsidiary, and not as part of a scheme or arrangement the main purpose, or one of the main purposes, of which is to enable the seller to participate in profits without receiving a dividend or to avoid tax (s 1033(2)). Statement of Practice 2/82 gives as examples of circumstances where the trade benefit test will be regarded as satisfied:

- a disagreement between shareholders over the management of the company which is having an adverse effect on the company's trade and where the effect of the transaction would be to remove the dissenting shareholder entirely; and
- ensuring that an unwilling shareholder who wishes to end his association with the company does not sell his shares to someone regarded as unacceptable by the other shareholders.

In that statement, HMRC also say that if a seller retains a directorship or appointment as a consultant the trade benefit test will probably not be satisfied.

Residence and period of ownership tests

The seller must be UK resident and ordinarily resident in the UK in the tax year in which the shares are sold. In addition, the shares must in normal circumstances have been owned by the seller for at least five years ending with the date of the sale (s 1034 to s 1036).

Substantial reduction test

The seller's interest as a shareholder must be substantially reduced by the sale. This is a mathematical test and there are two parts which both need to be satisfied:

- *The seller's interest as a shareholder* (the total nominal value

of the shares owned by him expressed as a proportion of the company's total issued share capital) must be substantially reduced by the sale. This part will be satisfied if his post-sale interest is not more than 75% of his pre-sale interest. In calculating the post-sale interest the reduction of the issued share capital as a result of the buyback must be taken into account (s 1037).

- *The seller's entitlement to a share of the profits* available for distribution must also be substantially reduced and this test will be satisfied if his post-sale entitlement is no more than 75% of his pre-sale entitlement (s 1037 to s 1041).

Connection test

Immediately after the sale the seller must not be connected with the company or any other group company (s 1042). A person is connected with a company if he directly or indirectly possesses, or is entitled to acquire, more than 30% of:

- the issued ordinary shares;
- the loan capital and issued ordinary shares; or
- the voting power.

He is also connected if he directly or indirectly possesses, or is entitled to acquire, rights to more than 30% of the assets which would be available for distribution on a winding-up (s 1062).

How it works in practice

Capferret Ltd is a trading company based in Leeds which manufactures and distributes a type of ball bearing called a googly. It has 100 shares in issue: 50 are owned by Colin, the non-executive chairman, and Ryan and Tim own 25 each. Ryan and Tim consider that the company's recent dismal trading performance is largely due to the fact that they and Colin are unable to agree on a strategy for running the business.

Ryan and Tim have provisionally agreed with Colin that the company will buy back all his shares for a total consideration of £1m. However, the company does not have the distributable reserves it needs to complete the purchase in one go. Ryan and Tim have therefore proposed to Colin that the company buys back his shares via a multiple completion contract. This would be a single unconditional contract under which Colin disposes of his entire beneficial interest in all 50 shares on the date the contract is entered into, but the sale is completed in five tranches of ten shares each.

Payment of £200,000 for the first tranche of ten shares will be made on the date the buyback agreement is entered into with completion of the remaining four tranches being made on successive anniversaries of the date of the buyback agreement (subject to sufficient distributable reserves being available on the relevant dates).

Terms of the agreement

The buyback agreement should be drafted so that it is a single unconditional contract under which Colin sells his entire beneficial interest in all the shares, subject to the agreement on the date it is entered into. It is probably a good idea for the

agreement to state specifically that with effect from the date it is executed, Colin:

- acknowledges that he has no beneficial interest in the shares and holds the un-cancelled shares as nominee and bare trustee for the company;
- will transfer the legal ownership of the shares on the relevant completion dates and will not otherwise transfer, deal with or dispose of the shares save as the company directs;
- acknowledges that he is not entitled to exercise any rights attaching to the un-cancelled shares such as voting and dividend rights, rights to participate in a distribution of assets on a winding-up and any pre-emption rights contained in Capferret's articles of association.

As long as the terms of the buyback agreement are explained to HMRC in the clearance application, clearance should be forthcoming. However, there may be challenges from HMRC.

Company law

As mentioned, company law prohibits unquoted companies from paying for their shares in instalments. HMRC may wrongly challenge an application for clearance on the basis that a multiple completion buyback is not a valid way of structuring a buyback as a matter of law.

“ ‘Beneficial ownership’ is not defined for tax purposes. ”

Companies Act 2006, s 691 (and its predecessors) states that a limited company may purchase its own shares as long as they are fully paid and are paid for on purchase. This point was specifically considered in the ICAEW technical release 745 issued in April 1989 which relates to own share purchases and which HMRC agreed to the publication of. Paragraph 10(a) on page 19 of the release says:

‘They [the Inland Revenue] confirm that payment by instalments is prohibited. But they are advised that a company may contract to buy shares for completion to take place for particular numbers of shares included in the sale on different dates without contravention of the Companies Acts.’

The second bullet point on page 4 of *Tax Bulletin 21* states under the heading ‘Purchase by an unquoted trading company of its own shares’:

‘The board can only consider a request relating to a transaction which appears to be a valid purchase of own shares. The Companies Act 1985 lays down certain procedural rules which must be followed. Also, the consideration for the shares must be paid immediately and must be paid in money. The first of these requirements means that payment in instalments is not possible. It is, however, possible to make a contract under which

successive tranches of shares are to be purchased on specified dates.’

Any attempt by HMRC to argue that a multiple completion buyback is not a valid means of structuring a purchase of own shares within the Companies Acts can therefore be firmly resisted.

Tax law

The conditions for capital treatment in CTA 2010, s 1033 to s 1043 will also need to be met. Some of these are an objective question of fact, irrespective of how the actual buyback is structured:

- Capferret is an unquoted trading company; and
- Colin has owned his shares for more than five years and he has been both UK resident and ordinarily resident for several years.

So the trading and unquoted status and residence and period of ownership tests are all satisfied.

Given the deterioration of the relationship between Colin, Ryan and Tim as shareholders and their inability to agree on how the business should be run, there is a strong case to support the trade benefit test being met. The company's dismal trading performance would indicate that the trade is suffering as a result.

Before looking at whether the substantial reduction and connection tests are met mathematically, it is necessary to look at the concept of ‘ownership’ for the purposes of these tests since, in our experience, this is another basis on which HMRC may challenge an application for clearance.

CTA 2010, s 1048(3) says references in s 1033 to s 1047 to the owner of shares are to the beneficial owner (except where the shares are held in trust or are comprised in the estate of a dead shareholder). Section 1038(6) (which deals with the entitlement to profits part of the substantial reduction test) says that references in that section to entitlement are, except in the case of trustees and personal representatives, references to beneficial entitlement.

According to paragraph 10(b) of the ICAEW technical release:

‘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.’

‘Beneficial ownership’ is not defined for tax purposes but *Butterworths Law Dictionary* (11th edition) defines a beneficial interest as ‘a right of substantial enjoyment or equitable interests as opposed to merely nominal ownership or legal interest’.

It seems clear therefore that provided the buyback agreement is drafted along the lines summarised above, there will have been a disposal of the beneficial ownership of Colin's shares and thus a disposal for the purposes of CTA 2010, s 1034 to s 1043 on the date the buyback agreement is entered into. Provided he is still a director on the date of the buyback agreement and the other conditions for entrepreneurs' relief are satisfied, Colin should pay capital gains tax at 10% on his gain.

As long as under the terms of the buyback agreement Colin disposes of his entire beneficial interest in all his shares at the date the agreement is entered into, the substantial reduction test will be satisfied, notwithstanding that he remains the legal owner of the shares subject to the uncompleted tranches until they are completed.

Voting rights

For the same reason, the mathematical connection test should also be satisfied. HMRC may argue that it is not for two reasons:

- the uncancelled shares still carry voting rights and thus Colin has more than 30% of the voting power; and/or
- the outstanding consideration is loan capital.

In response to the first argument, even though, as a matter of company law, while the shares continue to exist so do the voting rights attached to them, that is not relevant for the purposes of the connection test. Once he has entered into the buyback agreement, Colin has contractually disposed of his beneficial interest in the shares and is therefore no longer legally able to exercise those voting rights. If HMRC are still of the view that the seller has the voting power attached to the uncancelled shares, a simple solution would be to redesignate them as a separate class of non-voting share, but this should not be necessary.

HMRC may also argue that Colin is still connected with Capferret by reason of having more than 30% of the loan capital.

Again, this can be resisted since no debt arises in law until the completion date. CTA 2010, s 1063 defines the loan capital of a company as a debt incurred:

- for any money borrowed or capital assets acquired by the company;
- for any right to receive income created in favour of the company; or
- for consideration, the value of which to the company was, at the time the debt was incurred, substantially less than the amount of the debt.

Therefore even though Capferret must treat its obligation under the buyback agreement as a creditor for accounting purposes, this does not fall within the definition of 'loan capital' and it does not therefore establish a connection.

Conclusion

A multiple completion buyback will not always be the best means of structuring a buyback for many and varied reasons, but provided the buyback agreement is properly drafted, it is capable of meeting the conditions for capital treatment. Anyone applying for clearance under CTA 2010, s 1033 should, however, be aware that they may have to argue the case with HMRC more strongly than in the case of a conventional buyback. ■

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