

# Buyback mountain

Achieving the summit of 10% capital gains tax could be problematic for small shareholders affected by share buybacks from other shareholders, explains **KEVIN SLEVIN**.

As we grow accustomed to working with the capital gains tax entrepreneurs' relief provisions, it seems that hardly a month goes by without a new practical point arising. This article highlights one matter that arose recently. Although, with the benefit of hindsight, such points may appear blindingly obvious, they can so easily be overlooked; consequently, the matters discussed here may seem small, but should not be described as nit-picking. There is nothing trivial or inconsequential about prejudicing a shareholder's expectations of successfully claiming such a valuable relief.

## Company purchase of own shares

Sara Cohen's article "Multiple attraction" (*Taxation*, 13 October 2011, page 14) focused on the increasing use of contracts whereby a company agrees to buy back shares from the vendor shareholder under a single contract containing a schedule of multiple completion dates. Broadly speaking, these contracts are structured to overcome the restrictions in the Companies Act 2006 which prevent any part of the consideration being left outstanding (or indeed deferred in any way) in a buyback, while still potentially meeting the conditions for the so-called capital treatment found in CTA 2010, s 1033.

Part of the arrangements of a multiple completion buyback will involve the creation of a single unconditional binding contract between the intending vendor shareholder and the company in question. The contract will provide for the company to "complete" on several occasions so that it takes possession of the shares in tranches. The theory is that a properly worded

### KEY POINTS

- Share buybacks using multiple completion dates can be advantageous for vendors.
- The disadvantage of an upfront tax payment will be outweighed by a reduced tax rate.
- The reduced overall shareholding level can affect those with small shareholdings.
- Examples illustrate the potential problems.
- The importance of a properly maintained share register.



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contract drawn up by an experienced solicitor should trigger a capital gains tax disposal of all the shares to be sold back to the company as at the date of the contract, while still facilitating the payment on a phased basis so as not to breach the Companies Act 2006 provisions.

Readers should refer to Sara's article to examine the issues surrounding such arrangements and the potential benefits of satisfying both the Companies Act 2006 conditions regarding the buyback of shares by a company and the tax-related provisions found in CTA 2010 enabling "capital treatment" to be enjoyed by the shareholder. The essence of these types of arrangement is that they are structured so that the beneficial interest in all of the shares being disposed of under the contract passes immediately the binding contract is entered into, while completion is staggered. All shares bought back by private companies should be cancelled immediately because only listed companies are permitted to hold bought-back shares as so-called Treasury shares.

As the scheduled completion dates arrive in respect of each of the subsequent tranches of the outgoing shareholders' holding, the company will complete by making the payment to the shareholder. The shareholder will hand over the shares and the company will immediately cancel that tranche until the legal interest in the vendor shareholder's entire former holding has been acquired by the company. With a fair wind and a good solicitor all objectives are achievable.

**Fred** is an illustration of such a buyback transaction. It is, of course, necessary to show that the qualifying conditions of entrepreneurs' relief have been met throughout the 12 months ending on the creation of the binding contract.

In **Fred**, the shareholder is happy to pay capital gains tax at 10% on his entire gain, even though he knows that he will have to wait some time before all of the consideration is received. (A discussion as to the implications of TCGA 1992,

**FRED**

Fred owns ordinary shares in G Ltd, a successful trading company. He is 48 and wishes to retire from business.

On 13 July 2013, Fred enters into a binding multiple completion buyback contract with G Ltd to sell the whole of his shareholding to the company in tranches starting on that date. HMRC officials have given clearance that the consideration will be regarded as a capital payment. All the requirements of a successful claim to capital gains tax entrepreneurs' relief were satisfied during the 12 months ended 13 July 2013.

For entrepreneurs' relief purposes, the gain on the whole shareholding will crystallise on 13 July 2013. Fred will self-assess the whole capital gain for 2013/14, even though part of the consideration arising under the contract will not become payable until the following years. Thus, the date on which the contract is entered into determines the relevant period to be examined to establish the availability of entrepreneurs' relief in respect of the capital gain arising.

s 48 in the event of the company failing to complete on one or more outstanding tranches of shares is outside the scope of this article).

**“ The company's total issued share capital will have been decreased by the cancellation of the shares in question. ”**

## The aftermath

In *Fred*, the first tranche of shares acquired by G Ltd were immediately cancelled on 13 July 2013 and the company's total issued share capital will have been decreased by the cancellation of those shares on that date. Note that, although the number of issued shares held by the other shareholders remains unchanged, their shareholdings increase as a percentage of the reduced overall level of ordinary share capital.

Although Fred has agreed under the contract for sale to the company that he can no longer exercise voting rights or be entitled to dividends in respect of them, his remaining shares have not been cancelled and therefore still exist on the company register. These “uncompleted shares” remain part of the issued share capital of the company. Furthermore, if we assume that nothing has been done post-contract to modify the dividend rights attached to the uncompleted shares under the memorandum and articles of association of G Ltd, the uncompleted shares will remain “ordinary shares” as defined by ITA 2007, s 989 (see TCGA 1992, s 169S(5)).

As a consequence, if the uncompleted shares remain ordinary shares for entrepreneurs' relief purposes, they

can affect the entitlement to entrepreneurs' relief by the other shareholders for up to 12 months after the ultimate completion of the contract with Fred.

That will not worry Fred, but there are possible implications for the other shareholders.

## The personal company test

Continuing the example of *Fred*, let us now assume that we are looking at a situation where a takeover bid for the company arises just after the third anniversary of Fred's buyback contract with G Ltd.

On 13 July 2016, G Ltd completes its obligations under the buyback contract with Fred, thereby acquiring a final tranche of 1,000 ordinary shares from him. That holding of 1,000 shares will be immediately cancelled reducing the issued ordinary share capital of G Ltd from 16,400 to 15,400 £1 ordinary shares.

Let us also assume that a takeover bid is received for the entire share capital of the company in December 2016 and this is finalised on 22 February 2017. On that date, a contract is signed whereby all issued shares are disposed of and all the other shareholders are hoping to claim entrepreneurs' relief in respect of their individual gains.

Each shareholder wishing to claim entrepreneurs' relief will need to examine the period of 12 months ending on 22 February 2017 to establish whether G Ltd can be said to be their “personal company”.

At this point, it is worth reminding ourselves that one of the requirements of a successful claim to entrepreneurs' relief in respect of share disposal is that, throughout the period of 12 months ending on the disposal date, the claimant must be able to demonstrate that:

- they have owned at least 5% of the ordinary share capital of the company; and
- by virtue of their holding of shares, they were able to exercise not less than 5% of the voting rights in the company.

Both of these requirements must be made throughout the 12-month period. If we now look at the example of *Helen* we can see the difficulties that may arise.

**HELEN**

Helen has worked for G Ltd for many years as an employee. Throughout the 12 months ending on 22 February 2017 she owns 770 shares in G Ltd. She receives £550,000 on the takeover, thereby realising a substantial gain on which she hopes to pay only 10% tax.

However, although Helen can show that she has owned 5% of the issued ordinary share capital since 13 July 2016 because she has owned 770 shares out of 15,400, for the period 23 February 2016 to 13 July 2016, her holding represented only 4.695% of the total issued share capital; she owned 770 shares out of the then issued share capital of 16,400 £1 shares.

Accordingly, in *Helen* the shareholder should not claim entrepreneurs' relief. Only if she were to dispose of her shares after 13 July 2017 would entrepreneurs' relief be available to Helen in respect of the gain thereon.

Although Helen may be able to say she has possessed 5% of the exercisable voting rights throughout the 12 months before the disposal, this is not sufficient for her to qualify for relief. The definition of the phrase "personal company" in TCGA 1992, s 169S(3) is clear in this respect.

## A supplementary point

A question that can arise is at what point can it be said that a share has been cancelled? It is understood that HMRC hold the view that a share is not cancelled until the share register shows it to have been cancelled. This is not an unreasonable view.

Therefore, a practitioner who promises to update the company records, but who does not get around to doing so until, say, some months later, will be prolonging the problem highlighted above. For example, in *Helen*, if we now assume that the company accountant updates the share register on 18 December 2016 on hearing of the possible takeover, Helen will not satisfy the 5% personal company test until 18 December 2017.

Not only is it a good thing to get the share cancellation carried out promptly, it is also advisable to have this recorded as soon as possible. This could be either in a board minute in respect of a meeting shortly after it was carried out or in an email from the professional adviser to the managing director (or company secretary) on the day in question.

## Conclusion

Although a contract involving multiple completions in respect of different tranches of shares can make an unworkable buyback workable, it can be seen that other continuing shareholders need to examine their own position. Officers or employees with small shareholdings hovering just above the 5% level after all of tranches of a buyback transaction from an outgoing shareholder may find that they do not satisfy the 5% personal company tests until all of the buyback shares have been cancelled – and even then only when the share register has been updated.

Finally, readers should not just focus on capital gains tax when advising on the impact of contracts with multiple completions because immediately such a contract is signed inheritance tax business property relief will be lost. Reverting to the example of *Fred* above, practitioners should not forget that, if Fred dies soon after the contract is entered into, his inheritance tax position will have been adversely affected by the transaction. Of course, if Fred had been told this in advance he would probably still have gone ahead, but how long would it be before one of Fred's adult children starts to suggest that he would not have proceeded with the contract had he been better advised? Advice in this area should be captured in writing. ■

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