# BUYING OUT A DEPARTING SHAREHOLDER

**A technical outline of the tax planning opportunities**

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# INTRODUCTION

This report will consider the different options available when a shareholder in a company wishes to retire or otherwise depart and the other shareholders wish to buy him out.

The two primary routes used are for the company to purchase its own shares or for the continuing shareholders to establish a new company that acquires the old company's shares in exchange for shares to the continuing shareholders and cash to the departing shareholder.

It is possible for the existing shareholders to purchase the shares directly but this is rarely an attractive option as it means that the cash to finance the purchase must come from personal funds that generally have suffered higher rate tax. By having either the company itself or a new company finance the transaction this additional tax cost is avoided.

The report focuses on the tax issues but mention is made of other issues, e.g. company law, where appropriate.

This is not intended to be an exhaustive treatment of the subject but to highlight a number of issues that crop up in practice with suggested solutions where appropriate.

It is assumed that the price for the shares is fixed as is usually the case in this type of situation. Earn out clauses are more common when a company is being sold to a third party and the tax issues of these will be considered in a separate Tax Options publication.

It is also assumed that the basic rules are understood by practitioners but for completeness we have included extracts from HMRC manuals and legislation which practitioners may find useful.

# PURCHASE OF OWN SHARES

## 1. Introduction

A purchase of own shares is usually the better way to buy a shareholder out compared to using a new company.

Normally a payment by a company to one of its shareholders is taxed as a dividend liable to higher rate tax. However, if the conditions in CTA 2010 s1033 et seq are satisfied, the disposal is treated in the same way as a simple sale of shares, i.e. only liable to capital gains tax. This means that, provided the conditions for entrepreneur's relief are satisfied, the profit will only be subject to 10% tax.

*Advantages*

- Stamp duty (at ½%) only payable on the value of the shares acquired rather than the whole company.
- Additional costs involved in establishing and running a second company avoided.
- Problems with an extra associated company for small company corporation tax rate purposes avoided

*Disadvantages*

- Company law requires that a purchase of own shares must be paid in cash on completion. This can make the financing difficult.
- Need to satisfy the conditions in CTA 2010 s1033 et seq.
- Need to satisfy other company law requirements such as sufficiency of reserves (preferably revenue reserves but purchases out of capital reserves are possible)
- Where either of the loan back routes are used for financing, if loans are ultimately not paid, the loss may not be able to be set against the original gain

The following paragraphs consider some of these issues in more detail.

## 2. Financing

It is rare for the continuing shareholders and/or the company to have sufficient cash to pay for a departing shareholder's shares outright. Usually it is necessary to find some of the cash from future profits.

However, company law [CA 2006 s691(2)] requires that a purchase of own shares be paid in full on completion. So payment by instalments is not allowed. Sometimes this proves to be an insurmountable hurdle but there are some solutions that may work, depending on the individual circumstances.

Failure to be able to deal with the financing is the most common reason why a purchase of own shares may not work and therefore the new company option has to be used.

a. **Deferred completion**

There is a single contract to sell the shares but completion is staggered with only a few shares being paid for in full at each completion date.

The main potential stumbling block to this is the requirement in CTA 2010 s1037 that the shareholder's holding must be "substantially reduced". This says that, for a purchase of own shares to be capital, the selling shareholder's holding, expressed as a percentage of the whole, must be 75% or less of the percentage before the sale. In these circumstances this rule must be satisfied each time there is a completion.

It might be acceptable if the condition is only broken on one or two of the stages and thus the bulk of the proceeds can be taxed as capital gains.

b. **Loan back**

The contract is completed in a single stage but the vendor lends some of the sale proceeds back to the company.

The main potential stumbling block in this case is the requirement in CTA 2010 s1042(1) that the seller must not be "connected" with the company following the sale. Connected is defined in CTA 2010 s1062 and includes a situation where a person holds more than 30% of the loan capital and issued share capital combined. Thus, if the nominal value of issued shares is small (even though the actual value of the shares may be much larger) and there is little or no other loan capital (bank loans are excluded for this purpose), there is a strong probability that this condition will be broken.

One way to overcome this might be for the company to make a bonus issue to increase the nominal value of the shares.

A second potential stumbling block is the condition in CTA 2010 s1033(2)(a) that the purchase is wholly or mainly for the benefit of the company's trade. This condition is discussed in more detail in section 3 below but HMRC may consider the condition broken if the terms of the loan, e.g. payment on demand, are such that might put the company's trade at risk.

c. **Indirect loan back**

A possible way to circumvent the connection test mentioned in the previous paragraph is for the seller to make the loan to one or more of the remaining shareholders who then, in turn, lend the money to the company.

In clearance applications, HMRC has been happy with this arrangement provided again that the terms of the loan by the seller are not such that might put the company's trade at risk (see final paragraph in the preceding section).

The other shareholders may not be keen on this idea as they will remain liable if the company fails (unless the terms of the loan cover this by, for example, making the loan non-recourse) and so it is likely only to be useful where, for example, parents are being bought out to make way for their children.

## 3. Benefit of the trade

Most of the conditions imposed by CTA 2010 s1033 et seq are objective. In other words it is clear whether they are satisfied or not, e.g. the five year ownership test [CTA 2010 s1035].

The only subjective tests are found in s1033(2) as follows

(a) the redemption, repayment or purchase is made wholly or mainly for the purpose of benefiting a trade carried on by the company or any of its 75% subsidiaries,

(b) the redemption, repayment or purchase does not form part of a scheme or arrangement the main purpose or one of the main purposes of which is—

  (i) to enable the owner of the shares to participate in the profits of the company without receiving a dividend, or

  (ii) the avoidance of tax

End quote

Thus, clearly, a purchase of own shares cannot be employed unless the company is a trading company or a member of a trading group as there is no trade to benefit.

In practice it is usually test (a) that can cause difficulty. Guidance on HMRC's interpretation of this test can be found in Statement of Practice 2/82.

In particular it is worth considering the following paragraph from the guidance:

If the company is not buying all the shares owned by the vendor, or if although the vendor is selling all his shares he is retaining some other connection with the company - for example, a directorship or an appointment as consultant - it would seem unlikely that the transaction could benefit the company's trade, so the trade benefit test will probably not be satisfied. However, there are exceptions; for example, where a company does not currently have the resources to buy out its retiring controlling shareholder completely but purchases as many of his shares as it can afford with the intention of buying the remainder where possible. In these circumstances, it may still be possible for the company to show that the main purpose is to benefit its trade. Also, the Commissioners for Her Majesty's Revenue and Customs do not raise any objection if for sentimental reasons it is desired that a retiring director of a company should retain a small shareholding in it, not exceeding 5% of the issued share capital.

End quote

This is important. As the paragraph states, HMRC is highly reluctant to accept that the trade benefit can be satisfied unless the shareholder is being bought out completely. Conversely, if the shareholder is being bought out completely, it is unlikely that HMRC will raise any objection. Thus in general terms the test becomes "is the shareholder being bought out completely and severing connections with the company?". However, it can go wider than that.

HMRC will normally accept some continuing employment of the individual if the intention is to run this down over a period (phased retirement) and this period could be a few years rather than just a few months. But HMRC is very likely to insist that phased retirement does not include remaining as a director.

As mentioned in 2 above, the trade benefit test is also relevant when considering loans back to the company, either directly or indirectly.

Wider issues may be considered on occasion, for example in the case Allum and anor v Marsh [2005] STC (SCD) 191, it was held that the trade was not being benefitted as the purchase of own shares was being funded primarily by the sale of the company's premises leaving it without trading premises.

## 4. Tax clearance

Because of the subjectivity of the trade benefit test, it is generally recommended to seek advance clearance from HMRC (see Compliance section).

If HMRC is unable to accept the proposal, it may be possible to amend it to make it acceptable.

## 5. Capital or revenue

It should be noted that, if the conditions are satisfied, treatment as capital is automatic, not a matter of making an election.

In the light of increasing capital gains tax rates where entrepreneur's relief is not available, a shareholder may prefer treatment as income.

A dividend is tax-free to the extent it falls within the basic rate tax band. At the higher rate of 40%, the effective tax rate is 25% of the net dividend compared to 28% capital gains tax. Only at the top rate of 50%, where the effective rate on the dividend becomes 36.1%, does it become more expensive. On the other hand the capital gains tax annual exemption (£10,600 in 2011/12) will not be available.

To obtain income treatment, it then becomes a matter of breaking at least one of the conditions for capital treatment.

There are a number of possibilities depending on the circumstances. Some suggestions are:

a. Break the five year ownership period by transferring the shares to another person (not a spouse). An unmarried partner is perfect for this.
b. Break the connection test by lending the proceeds back to the company for a short while.
c. Break the residence test by transferring the shares to a non-resident nominee.

## 6. Tax treatment

Assuming that the purchase of own shares is treated as capital there is a disposal for capital gains tax purposes on the date of the original agreement.

This is not an issue when payment is made in full at that time. However, it is important to consider the implications if one of the financing routes in section 2 above is adopted.

a. **Deferred completion**

The date of the original contract determines the date of disposal for capital gains tax [TCGA 1992 s28] but there can be no disposal until the contract is completed. This means that, as completion occurs on tranches of shares, the disposal date is the original date of the contract. This can mean that the due date of the tax might fall before the cash is received. Interest will then be due.

If parts of the contract are never completed, perhaps because the company becomes insolvent, no tax will be due in respect of shares where the sale was not completed.

b. **Loan back**

Under the loan back route, capital gains tax is due based on the date of the original contract. It is not possible to apply the hardship provisions in TCGA s280 as HMRC will consider that the whole consideration was paid on that date. For the same reason TCGA 1992 s48 (consideration due after time of disposal) cannot apply and therefore, if part of the loan is never repaid, no relief is available against the original gain. It is likely to be possible to claim a capital loss under the provisions of TCGA 1992 s253 but, as capital losses cannot be carried back to an earlier tax year, this will be of limited use unless the loan becomes irrecoverable in the same tax year.

c. **Indirect loan back**

The comments in b above apply here but there is not even scope for claiming a loss under s253.

# NEW COMPANY

## 1. Introduction

Where the conditions in CTA 2010 s1033 et seq (and income treatment is not desired) or the company law requirements cannot be satisfied, the alternative is to use a new company.

## 2. Outline transactions

a. A new company ("Newco") is formed owned by the shareholders of the existing company ("Target") who are to remain, in the same proportions as in Target.
b. Newco acquires Target in exchange for cash (perhaps some deferred) and/or loan notes to the departing shareholder and an issue of new ordinary shares to the remaining shareholders.
c. Target pays a dividend and/or lends cash to Newco to provide it with funds to meet its cash requirements to fund the purchase.
d. Optionally the trade of Target is transferred to Newco and all reserves paid as a dividend to leave Target as a dormant shell.

## 3. Financing

Often there will not be sufficient cash available to buy the departing shareholder out in cash immediately. If cash is available then it is likely that a purchase of own shares will be a better route.

The two methods to deal with deferred consideration are either to pay the total by instalments or to use loan notes.

### a. Instalments

Payment by instalments is simple. The contract will specify when instalments will fall due and the consequences of delay in payment.

Instalments could carry interest from the date of the original sale but generally this is not recommended. It is usually better to set the capital sum higher and not pay interest. This is because the vendor will pay income tax on the interest (although Newco will be eligible for corporation tax relief) instead of paying 10% capital gains tax on a larger capital gain. Of course, if the vendor is not eligible for entrepreneur's relief, payment of interest might be a more attractive option.

Capital gains tax is due in full based on the original disposal date (i.e. on 31 January following the tax year of disposal). However, TCGA 1992 s48 provides that, if any part of proceeds become irrecoverable, a claim can be made to adjust the original capital gains tax computation to exclude the irrecoverable proceeds.

TCGA 1992 s280 also provides that, where instalments are paid over a period in excess of 18 months, a person may choose to pay the tax over a period. HMRC practice is to require a person to pay at least 50% of each instalment as tax until the liability is extinguished.

b. **Loan notes**

Under this option, Newco issues loan notes to the vendor that are redeemed in cash over a period.

In this case, the capital gain is calculated as if the whole proceeds were cash but it is then split between the cash element, if any, and the loan notes in proportion to their values. The gain attributable to the cash is taxed as normal. The gain attributable to the loan notes only becomes taxable based on the dates the loan notes are redeemed.

Tax clearance should be sought under TCGA 1992 s138 but this is likely to be given except in unusual circumstances.

There are two benefits of this:

- Tax payments are deferred to later tax years.
- Available capital gains tax annual exemptions can be applied in later tax years.

However, there is a major disadvantage that has been illustrated by the changes made by Finance (No 2) Act 2010. Because the gains become taxable in later tax years, they will be subject to capital gains tax rates in those later years.

Prior to 23 June 2010, the mechanism for entrepreneur's relief and loan notes was that the gain was reduced by 4/9ths and only the reduced gain was triggered by the redemption of loan notes to be taxed at 18%. By this mechanism the effective rate of tax was 10%. Finance (No 2) Act 2010 has abolished the 4/9ths reduction in favour of three rates of 10%, 18% and 28%.

The effect of these changes on loan notes is quite drastic. Gains linked to loan notes issued before 23 June 2010 but redeemed on or after that date will be liable to tax at 28% (unless within the basic rate band then at 18%). If at 28% then the effective rate of tax on the loan notes becomes 15.6% rather than 10% (the 4/9ths reduction having been given previously).

For loan notes issued on or after 23 June 2010, the position is even worse. There is no 4/9ths reduction and the loan notes will normally (but see comments below) not be eligible for entrepreneur's relief. Thus the gains will be taxable at the full rate of either 18% or 28%.

There are two solutions to this problem.

The first is that one can elect [TCGA 1992 s169R] to disapply the provision to roll part of the gain into the loan notes and trigger the whole gain at the date of original disposal. This allows entrepreneur's relief to be claimed in full but, of course, the two benefits of loan notes are lost.

In this scenario it would be better not to take loan notes at all but simply agree to receive payment by instalments. The reason is that, as discussed in more detail below, instalments provide a form of bad debt relief whereas loan notes do not.

The second requires that Newco remains the personal company of the vendor and he continues as an officer or employee of Newco or Target at least until the loan notes are redeemed in full. This is because entrepreneur's relief can apply to all disposals of shares or securities [TCGA 1992 s169I(2)(c)] provided these two conditions are satisfied. Loan notes are classed as securities for this purpose (even if they are, as is normal, unsecured). To be a personal company, an individual must own at least 5% of the ordinary share capital and at least 5% of the voting rights [TCGA 1992 s169S(3)].

Another problem with loan notes is where the loan notes are not paid in full. As noted above, where instalments are not paid in full, TCGA 1992 s48 provides an adjustment to the original capital gains tax computation. S48 does not operate where loan notes have been issued.

Most loan notes are technically termed "qualifying corporate bonds". A gain or loss on a qualifying corporate bond is not chargeable or allowable [TCGA 1992 s115]. This means that special rules are required where a gain from shares is rolled into a qualifying corporate bond. The gain is calculated and part of that gain is deemed to accrue every time some of the loan notes are disposed of [TCGA 1992 s116(10)].

However, if a loan note is redeemed for less than full value, the gain is still triggered but the loss on the loan note itself is not allowable. If a company fails and the loan notes become valueless, TCGA 1992 s24(1) states that there is a deemed disposal of the asset. Thus the tax charge is triggered with no cash to pay it!

There are two solutions to this risk apart from the obvious of not taking loan notes in the first place!

- Before any deemed disposal or any redemption at a price less than the tax charge, the loan note holder gives the loan notes to a charity. Under TCGA 1992 s257, disposals to charities are deemed to be made at no gain/no loss. Some commentators believe that this only applies to the bond itself and not to the gain suspended under s116(10). However, as far back as May 1992, in Tax Bulletin 3, HMRC said that "there will no charge on the deferred gain either on the donor or on the charity on a subsequent disposal of the bonds". One might question why a charity would be willing to take a worthless bond. Presumably an appropriate donation (under gift aid of course and less than the potential tax charge) would ease the way forward!

- Instead of issuing the loan notes at the outset as qualifying corporate bonds, they are issued as non-qualifying corporate bonds. This idea was popular at the time taper relief was first introduced in 1998 in order to improve the taper relief position.

  A non-qualifying corporate bond remains a chargeable asset for capital gains tax purposes and hence the special rules in s116(10) do not apply. Consequently if the bonds become valueless, the gain rolled into them is washed out.

In order to achieve this, it is necessary to break the conditions for a corporate bond to be qualifying. The definition is found in TCGA 1992 s117. One popular method is to provide that the bond can be redeemed in a foreign currency. However, this cannot be based on an exchange rate ruling on the date of redemption [see s117(2)(b)].

## 4. Associated companies

By using a second company, the original company (if a single company) will acquire an associated company for small company corporation tax rate purposes. Thus, if the company's profits exceed £150,000 a year, the effective rate of corporation tax will increase.

There are three possible methods to avoid or reduce the problem

### a. Disregard under CTA 2010 s26

It is usually not possible to disregard the holding company under the provisions in CTA 2010 s26 because the subsidiary will paying dividends to the holding company to fund loan repayments. However, s26 could apply if funds for loan repayments were provided by way of a loan rather than as dividends and the holding company was not required to pay interest nor incur any other costs (other than minor expenses such as annual return fees).

With some care it would be possible to pay dividends in years when profits were expected to be below £150,000 with loans at other times.

### b. Shift profit into the holding company

Profit could be shifted into the holding company by a number of methods depending on the circumstances. The method most commonly employed is to create a management trade in the holding company. The holding company would supply the services of senior managers, perhaps just the shareholders themselves, to the subsidiary. If the shareholders are being remunerated primarily by dividend, the management charges made would be mostly profit for the holding company.

### c. Hive up

The subsidiary could transfer its trade into the holding company and the subsidiary become dormant.

Although this can be done tax-free, it represents a number of practical issues. The most common problem is that, being a new company, the holding company will be down-rated for credit purposes. In some situations, e.g. where relations are good with regular suppliers, this may not be a problem. In other situations this will mean that a hive up will not be commercially sensible.

## 5. Cash to existing shareholders

Clients will often ask whether it will be possible for the remaining shareholders to receive some cash at the time of the buyout. This is seen as a good opportunity to take some cash taxed at 10% rather than higher rates applicable to dividends.

The answer is, unless one can produce a very convincing commercial argument to do it (very difficult in practice), there is a risk that HMRC will issue a counter action notice under the provisions of ITA 2007 Part 13 Chapter 1 (artificial transactions in securities). If this is done, the sums received in excess of nominal value of the shares (and no, bonus issues cannot be used to boost the nominal value) will be taxed as dividends.

If such a transaction is contemplated and it is considered that there are some very good commercial reasons to support it, advance clearance can be sought under ITA 2007 s701.

# COMPLIANCE ISSUES

## 1. Purchase of own shares

### a. Advance clearance

Advance clearance can be sought that capital treatment (or, indeed, if preferred, income treatment) will apply to a proposed purchase of own shares.

The clearance application is made under the provisions of CTA 2010 s1044. The information required to be included is set out in Statement of Practice 2/82.

It is good practice to include an application under ITA 2007 s701 (transactions in securities) at the same time. However, it is highly unlikely that clearance would be given under s1044 but not under s701.

Clearance applications are made to a specialist unit in HMRC. A single application can be made under both of the above provisions. For details of where to send the application and the procedures for applying by email, see http://www.hmrc.gov.uk/cap under the Clearance and Counteraction Team, Anti-Avoidance Group.

### b. Notification of HMRC

If a purchase of own shares is carried out and capital treatment is claimed, it is necessary to write to the HMRC office dealing with the company's corporation tax affairs within 60 days of the transaction [CTA 2010 s1046]. The letter should set out details of the transaction but it is possible to include a copy of the clearance application if made assuming the transaction was carried out in line with the application.

## 2. New company

Clearance should be sought for the transaction under the provisions of TCGA 1992 s138 (paper for paper) and ITA 2007 s701 (transactions in securities).

S138 is a clearance procedure against the anti-avoidance provision in s137 that might trigger capital gains at the point shareholders dispose of their shares in the original company in exchange for shares (continuing shareholders) or loan notes (departing shareholder).

The clearance application is also made to the Clearance and Counteraction Team, Anti-Avoidance Group of HMRC as above.

There is no specific list of information required but the following is an example of how a clearance application might be laid out:

H M Revenue & Customs
Clearance & Counteraction Team
Anti-Avoidance Group
First Floor
22 Kingsway
London
WC2B 6NR

Dear Sirs

**XYZ LIMITED**

We are writing on behalf of our above named client ("XYZ") to request clearance under the following provisions:

1. S138 TCGA 1992

2. S701 ITA 2007

**Background**

**Proposed transactions**

1.

2.

3.

4.

**Commercial rationale**

[To the extent not covered in the Background section]

**Information**

[Details of shareholdings & tax references for individuals and company]

We enclose a copy of the latest approved accounts of XYZ Ltd being the year ended []

**Clearances**

We confirm that the transactions detailed above are being effected for bona fide commercial reasons and do not form part of a scheme or arrangements of which the main purpose, or one of the main purposes, is avoidance of liability to tax.

Please confirm that:

1. The provisions of s137 TCGA 1992 will not prevent the application of s135 Ibid to the reorganisation detailed above.

2. No notice will be given under the provisions of Chapter 1, Part 13, ITA 2007.

Yours faithfully,