X01 - Topic - Purchase of Own Shares (POOS)

POOS – 60 Second Checklist

Key points

Basic checks

- **S/h type:** Is the S/h a working or non-working S/h?
- **Reason:** For the share buy back?
- **Co type?** Unquoted trading Co or an investment Co?
- **Method of acquisition:** Were the shares purchased/subscribed/transferred from a spouse or inherited?
- **Length of ownership:** How long have the shares been held?

Income treatment

- **Applies:** If the capital conditions have not been satisfied
- **Tax impact:** Income tax using dividend rates. Income tax will be paid via self-assessment
- Dividend allowance
- **Check:** If the S/h is the original subscriber
- **Problem:** We can only use the original subscriber's base cost
- **Capital loss?** Compute the capital loss when the S/h's base cost exceeds the original subscriber's cost
- **Beneficial:** Only if the S/h is a basic rate taxpayer i.e. 7.5% dividend rate
- **Not beneficial:** For a higher rate taxpayer 32.5% or additional rate taxpayer 38.1%

Capital treatment

- Chargeable disposal of shares subject to CGT
- **Gain:** SP – C – AE = Taxable gain
- **Legislation:** Learn conditions under s.1033 CTA 2010
- **No election:** Applies automatically if all the conditions are met

Capital treatment – Conditions for the Co

- **Co type:** UQT i.e. the Co is wholly or mainly trading >50%. [The >20% of TAME test does not apply here]
- **Reason for buy-back:** You must appreciate what qualifies for benefit the trade test or to settle an IHT liability which would otherwise cause undue hardship
- **Problem:** If the long-term plan is to scale down activities or cease trading or disincorporation. Capital treatment will not apply

Capital treatment – Conditions for the S/h

- **Residence status:** S/h must be UK resident when the POOS takes place
- **Period of ownership:** Held shares for either 3yrs (if inherited on death together with deceased) or 5yrs (subscribed or purchased)
- **Spouse ownership:** Aggregated for transfers between spouses provided living together from transfer to POOS
- **CGT BADR?** Computing the gain and apply BADR if the S/h satisfies FTTW [BADR will be denied if the Co's non-trading activities >20% of TAME]
- **HMRC permits:** S/h retiring + keeping a small % (max 5%) or S/h disagreement (must buy back all shares)

Capital treatment – Conditions for % reduction & ownership post POOS

- **2 % tests:** To be met (i) Max 30% holding post buy-back + (ii) Min 25% reduction test
- **Connected parties:** Only includes spouse + children under 18
- **Problem re 30% test:** When considering the 30% test, this includes share capital + loan capital. May need to repay loans to S/h in order for the 30% condition to be met
- **25% test:** There must be a min 25% reduction of the shares held before the buy-back

Capital treatment – Admin

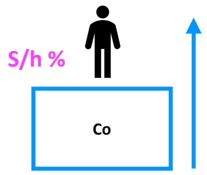
- **Clearance:** Recommend the clearance procedure to ensure the capital conditions are met
- **Tax avoidance:** State the obvious like no tax avoidance motive
- **POOS return:** The Co must however still make a return of the buyback giving details of the payment and the reasons why the capital treatment is considered to apply within 60 days after the payment.
- **Alternative option:** Sell shares for <MV + Gift relief scenario if shares are in an UQT Co + IHT BPR + PET re undervalue. Immediate gain will arise. Useful if shares have not been held for 3 or 5yrs or dissenting S/h wants to retain shares

Misc exam traps re capital treatment

- **Share valuation:** Has there been an independent valuation? HMRC could challenge this if there has been no valuation of the shares
- **Co payments:** The Co must pay for the buyback in full + in cash
- **Following are not classed as payments:** Transfer of an asset to a S/h or the creation of a loan account
- **Loan account credit balances:** Should be repaid to the S/h or his associates before the POOS takes place to ensure the 30% connection test is met
- **Check S/hs position post POOS:** Capital treatment denied if he retains >5% in the Co or continues to be a director or enters into a consultancy arrangement with the Co
- **Being paid >MV:** Excess taxed either as employment or dividend income

General Position

Key points

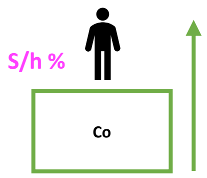


1. Payment to the S/h could either be taxed as an:
- Income distribution; or
- Capital gain

- ✓ **Problem scenario:** The POOS rules will apply when the S/h is **unable to find** a purchaser for his shares.
- ✓ **Solution:** As a result, the Co is **prepared to buy back** the shares from the S/h **on the basis** it has sufficient reserves to fund the purchase.
- ✓ **The payment to the shareholder:** Can **either be** taxed as an income distribution (using the normal dividend rates) **or** a capital gain subject to CGT **+** the 10% Business Asset Disposal Relief may apply (previously known as entrepreneurs relief) if the relevant conditions are met.
- ✓ **Co Articles must permit:** A Co purchase of own shares (POOS) must be **permitted** by the Co's articles of association.

Income Distribution

Key points



1. Taxed as dividend income = Capital conditions not met
2. Can only deduct the original subscriber's cost
3. Capital loss could arise if the S/h has not subscribed for the shares
4. £2,000 dividend allowance
5. Dividend rates: 7.5% + 32.5% + 38.1%

- ✓ **Most important check:** Is the S/h the **original subscriber**?
- ✓ **Tax impact:** If the capital conditions are **not met**, the payment by the Co, for the shares, will be taxed as an income distribution subject to the **dividend allowance** of £2,000 and **dividend rates** of income tax.
- ✓ **Calculating the dividend:** Payment from the Co **less** original subscription price in the Co.
- ✓ **What happens if the S/h is not an original subscriber?**
- \- **Calculating the dividend:** The **distribution** will be calculated using the sale proceeds **less** the original subscription price and **not** the actual price paid for the shares by the S/h.
- \- **Capital loss will arise:** The base cost **unallocated** will then equal an allowable capital loss which can be **offset** against chargeable gains in the current **or** subsequent tax years.

Example 1 – Income Distribution & Capital Loss Scenario

In 2015 Mr A and Mr B formed an investment Co. each. The Co has **2,000 £1 ordinary shares, were held equally** by both. In 2018 Mr A sold all his shares to to Mr X for MV **£100,000**.

In the last few months Mr X and Mr B have had serious disagreements over the strategic direction of the Co. It has been proposed that the Co will buy back all of Mr X's shares for **£500,000** on 1 March 2021. The Co has accumulated profit and loss account reserves of £3 million. Mr X is an additional rate taxpayer.

Answer

- ✓ **Is Mr X the original subscriber?** No. This means the **base cost** he will be permitted to use, is Mr A's original base cost of **£1,000** which means an allowable **capital loss** scenario will arise.

- ✓ **Tax impact:** The payment by the Co for the shares will be taxed as an income distribution subject to the **dividend allowance** of £2,000 and **38.1% dividend rates** of income tax since Mr X is an additional rate taxpayer.

- ✓ **Calculating the dividend:** Payment from the Co **less** original subscription price.

Income tax position:	**£**	**Capital loss position**	**£**
Sale proceeds	500,000	Price paid by Mr X	100,000
Less Mr A's original subscription price	-1,000	Less cost allowed to use	-1,000
Dividend	**499,000**		
£2,000 x 0% dividend allowance	Nil		
£497,000 x 38.1%	189,357		
Income tax liability	**189,357**	**Allowable capital loss**	**-99,000**

Example 2 – Exam Standard – Income Distribution

Rosh Ltd (RL) is a private limited company which holds a portfolio of commercial investment properties. Its **2,000 £1 ordinary shares** are held equally both brothers Roshan Rabheru (RR) and Ishaan Rabheru (IR). Both RR and IR are UK resident and directors of RL. They are both additional rate tax payers and they have not used up their dividend allowance.

RR is aged 70 and IR is aged 40. In the past RR has been the driving force behind the Co's success, but is now in poor health and wishes to retire so that IR may succeed to the business.

The Co has accumulated profit and loss account reserves of £2.5 million and has agreed to buy RR's 1,000 shares for **£1,001,000**. The Co's articles of association permit a company purchase of own shares. RR would like all his shares to be bought back. It is proposed that the purchase price for RR's shares should be paid in cash on completion of the buyback contract on 1 November 2020.

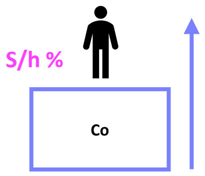
Answer

- ✓ **Is RR the original subscriber?** Yes. This means an allowable capital loss scenario **will not arise**.
- ✓ **Income treatment applies:** Because RL is **not** an unquoted trading Co. The holding of rental properties denotes it is an **investment Co**.
- ✓ **Calculating the dividend:** Payment from RL **£1,001,000** **less** RR's original subscription of **£1,000** = **£1,000,000** dividend.
- ✓ **Tax impact:** The payment by RL for the shares will be taxed as an **income distribution** after the dividend allowance of £2,000 **and** taxed at 38.1% dividend rate of income tax because RR is an additional rate tax payer.
- ✓ **Self-assessment:** Payment must be **disclosed** in his tax return and paid on 31 January 2022 (20/21).

	£
Buyback proceeds	1,001,000
Less RR's cost of shares	-1,000
Dividend	**1,000,000**
Dividend allowance £2,000 x 0%	Nil
£998,000 x 38.1%	380,238
RR's income tax liability	**380,238**

Capital distribution

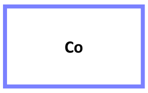
Key points



1. Taxed as a capital gain = Capital conditions are met
2. Deduct the actual cost of the shares
3. BADR could apply if the S/h satisfies FTTW

- ✓ **The capital conditions apply automatically:** This would be **mandatory** if certain conditions are met from s.1033-1095 CTA 2010.
- ✓ **If the conditions are not met:** Then the payment will be taxed as an **income distribution**.

Conditions to be met by the Co



- ✓ **Exam check:** Check the Co type **and** the purpose behind buying back the S/hs' shares. This will **help determine** the correct tax treatment.
- ✓ **UQT:** The company must be an **unquoted trading Co** (not an investment Co **or** trading plc) or holding Co of a trading group.
- ✓ **Trading Co test:** The business consists wholly or mainly of **carrying on a trade** i.e. **>50%** of the Co's activities must relate to a trading activity.
- ✓ **Benefit the trade test:** The shares being repurchased **must be** for the benefit of the trade (this applies to a S/h retiring **or** leaving following a dispute) **or** the S/h is selling the shares to settle an IHT liability.
- ✓ **Can a S/h still retain a % in the Co:**
- - **No:** If the reason for POOS is to remove a **dissenting S/h** where the differences cannot be resolved. Any attempt to retain a % will result in the POOS being taxed as an **income distribution**.
- - **Yes:** If the S/h is retiring **or** using the funds to settle an IHT liability. HMRC have accepted that **up to 5%** can be retained for sentimental reasons.
- ✓ **HMRC's view:** A **retiring director** who wishes to make way for new management.
- ✓ **Problem:** If the director subject to a POOS wishes to remain as a director, HMRC **may call into question** whether it is for the benefit of the trade.
- ✓ **No tax avoidance:** The purchase is **not part** of a scheme to avoid tax.

Conditions to be met by the individual

- ✓ **Exam check 1:** Check whether the S/h has subscribed/purchased **or** inherited the shares

- ✓ **5 year ownership test** s.1035 CTA 10**:** He must have held the shares for 5 years if the shares had been **purchased or subscribed**.

- ✓ **3 year ownership test:** If the S/h has **inherited** the shares **+** held them **together with** the deceased for at least 3 years.

- ✓ **Multiple purchases:** Where the S/h has **acquired** the shares on **separate dates**, then these acquisitions will need to **kept separate** when considering the period of ownership. All the acquisitions **cannot be aggregated** in to one single holding. There could be a situation where the period of ownership could be met for one holding and not another.

- ✓ **UK resident test** s.1034 CTA 10**:** He must be UK resident **in the tax year** in which the shares are bought back.

- ✓ **Dissenting S/h:** Where the share buy-back relates to a S/h disagreement, **HMRC have indicated** that the dissenting shareholder **should not retain** any shares post buy-back.

- ✓ **2 % tests:** The S/h **must satisfy** both % tests in order for the capital treatment to apply.

% test 1 – Cannot own >30% in the Co

- ✓ **Exam check 1:** Does the S/h's spouse/civil partner **+** children under 18 **also** own shares in the same Co.

- ✓ **Exam check 2:** In addition to the shareholding, has the S/h **or** associate also **loaned funds** to the Co that is being held as a **credit balance** on the loan account?

- ✓ **Connection test** s.1042 CTA 10**:** He must not hold **> 30%** in the Co's ordinary share capital **or** loan capital **or** voting power **following the** repurchase.

- ✓ **Definition of connection:** Includes spouse **and** children under 18.

- ✓ **Funds held on directors' loan account (DLA):** If ordinary share **and** loan capital combined **exceeds 30%**, it is worth **recommending** the credit balance on DLA be **withdrawn** prior to the POOS.

- ✓ **Small shareholding post POOS:** HMRC accept that a small %, **up to 5%** can be retained for a retiring S/h for sentimental reasons **but not** for a dissenting S/h.

% test 2 – Substantial reduction test

- ✓ **Main condition** s.1037-38 CTA 10**:** He must have **substantially reduced** his holding by at least **25%** of the pre-sale holding.

- ✓ **Example 1:** If the vendor held **30%** of the ordinary share capital prior to the purchase. Post-sale the maximum he can own is **22.5%** (**75% x 30%**).

- ✓ **Example 2:** Mr A's shares are being bought back by the Co. He has a **26%** holding in the Co **pre POOS**:

- **Family check:** Mr A's spouse **or** children under 18 **do not own** any shares in the Co.

- **Loan check:** Mr A and his associates have **not lent** any funds to the Co that is being held as a credit balance on the loan account.

- **Applying the 75% rule: 75% x 26% = 19.25%**. This means that the **maximum** % he can own in the Co **post POOS** is **19.25%**.

- ✓ **Combined interests:** The 75% held will be the combined interests of the seller **and** their associates prior to the POOS.

- ✓ **This test will fail:** If the seller and his associates' share of the profits **exceeds 75%** of their prior entitlement.

Clearance application & Procedure & Return

- ✓ **Advance clearance application** s.1044 CTA 10**:** May be made to HMRC **before** the POOS takes place.

- ✓ **HMRC will notify:** The Co that they are **satisfied** that the **capital treatment** under s.1033 CTA 10 applies.

- ✓ **The application:** Must be in **writing** and is usually laid in the **form laid out** in SP 2/82.

- ✓ **POOS return:** The Co must however still make a return of the buyback **giving details** of the payment and the reasons why the capital treatment is considered to apply (usually by attaching the clearance application and the clearance itself) **within 60 days** after the payment.

Example 3 – Exam Standard – Capital Distribution

Rosh Ltd (RL) is a private limited company. Same facts as example 1 except this time let us assume that the capital conditions have been met and that RR also meets all the conditions for Business Asset Disposal Relief (BADR).

	£
Buyback proceeds	1,001,000
Less RR's cost of shares	-1,000
Chargeable gain	**1,000,000**
Less CGT annual exemption	-12,300
Taxable gain	987,700
BADR: £987,700 x 10%	98,770
RR's CGT liability	**98,770**

Misc exam traps re capital treatment

- ✓ **Co trading status:** The Co's non-trading activities **exceed >50%**.
- ✓ **Share valuation:** HMRC could **challenge** the valuation if there **has not been** an independent valuation?
- ✓ **Co payments:** The Co must pay for the buyback **in full + in cash**.
- ✓ **Following are not classed as payments:** The capital treatment will be **denied** if the Co decides to **transfer** an asset to a S/h **or** the creation of a **loan account**.
- ✓ **Loan account credit balances:** Should be **repaid** to the S/h **or** his associates before the POOS takes place to **ensure** the 30% connection test is met.
- ✓ **Check S/hs position post POOS:** Capital treatment will be denied if he **retains >5%** in the Co **or** he continues to be a **director** or enters into a **consultancy arrangement** with the Co after the POOS.
- ✓ **Being paid >MV:** The excess value will be taxed **either** as employment **or** dividend income.

Example 4 – Past Paper Q – May 2016 OMB Advanced Technical – Sparks Ltd

Sparks Ltd is a private limited company which manufactures car batteries. Its 10,000 ordinary shares of £1 each are held as follows:

Gary Morrison	**5,000**
Mrs Wendy Morrison (wife of Gary)	**1,250**
Peter Morrison (son of Gary and Wendy)	3,750
	10,000

The Morrisons are all UK resident and are directors of the company.

When the company was formed in 1999, there was a fourth shareholder unrelated to the family who held **250 shares**. Gary acquired these shares on 1 July 2017 to bring his holding up to **5,000 shares**. Gary is aged 70, Wendy is aged 55 and Peter is aged 35. In the past Gary has been the driving force behind the company's success, but is now in poor health and wishes to retire so that his wife and son may succeed to the business.

The company has accumulated profit and loss account reserves of £1 million and has agreed to buy Gary's **5,000 shares** for **£500,000**. The company's articles of association permit a company purchase of own shares. Gary would however prefer to retain a small holding of shares for sentimental reasons but will resign as a director and will take no further part in the business. It is proposed that the purchase price for Gary's shares should be paid in cash on completion of the buyback contract.

Gary and Peter have overdrawn loan accounts with the company of £5,000 and £10,000 respectively. Wendy has a balance due to her from the company of **£30,000**.

Your firm has already done a review of the availability of Business Asset Disposal Relief (BADR) and has established that on a disposal of shares the relief would be available to Gary. The Tax Partner, Dan Fletcher, has asked you to consider whether the purchase of own shares will qualify for treatment as a capital disposal.

You are required to write a memorandum to the Tax Partner advising on the availability of the capital treatment on the repurchase of Gary's shares by the company.

Total 20 Marks

Introduction

- ✓ **Articles must permit:** A Co purchase of own shares (POOS) must be **permitted** by the Co's articles of association.
- ✓ **Tax impact for the S/h:** It is regarded as an **income distribution** and taxed as a **dividend** for income tax purposes **unless** the capital conditions are met.
- ✓ **CGT BADR:** Gary has already been advised CGT BADR will be available and the gain on disposal of the shares will be subject to CGT at only 10% assuming the capital treatment applies.
- ✓ **Recommendation:** The capital treatment is clearly preferable and applies **automatically** if the requirements are met.

Conditions for the Co

- ✓ **Co type:** The Co is an **unquoted trading Co**.
- ✓ **Benefit the Co's trade:** The POOS must be for the purpose of benefiting the Co's trade.
- ✓ **Apply:** Given Gary's health situation this **test should be met**.
- ✓ **HMRC guidance:** Gives an **example** of the 'trade benefit' test being met where a controlling shareholder wishes to retire to make way for new management.
- ✓ **A second condition**: Is that the POOS **must not be** to enable the owner of the shares to participate in the profits of the Co **without** receiving a dividend.
- ✓ **Apply:** Since Gary is **resigning** his directorship and will **not be involved** in the business in future this test also appears to be met.
- ✓ **Tax avoidance:** It is clear from the facts, that the proposed transaction **has not been designed** to avoid tax.

Conditions for Gary

- ✓ **Key issue:** Gary **acquired** the shares in **two tranches**:
  - **4,750 shares:** Original subscription since 1999.
  - **250 shares:** Acquired later in 2017.
- ✓ **The seller must be UK resident:** In the **tax year** in which the POOS is made.
- ✓ **Apply:** This test is met.
- ✓ **Ownership rule:** The shares must have been held for at least **5 years**.
- ✓ **Apply:** Which is clearly met in respect of **4,750** of Gary's holding.
- ✓ **The 250 shares acquired in 2017:**
  - **5 year ownership rule not met:** Have not been held for 5 years.
  - **Calculate the SP: £500,000** Total SP **divided** by **5,000** shares **= £100** SP per share. **250 shares x £100** SP per share **= £25,000** sale proceeds.
  - **Calculating the dividend:** This is the **difference** between the proceeds of sale i.e. **£25,000 less** £250 subscription price **= £24,750** being taxed as a dividend.

Substantial % reduction test

- ✓ **Understand the % held:** Gary holds 50% on his own i.e. **5,000** shares out of a total **10,000** pre POOS.

- ✓ **Include associates:** The combined interests of the seller **and** the seller's associates subsequently must not be more than 75% of their prior interests.

- ✓ **Apply:** Gary's wife holds **1,250 shares**. She will be classed as **an associate** for this purpose **but not** his son because he is over 18.

- ✓ **Their combined holdings:** Amount to **62.5% (6,250)** of the total share capital i.e. **5,000 + 1,250** out of a total 10,000 shares.

- ✓ **25% reduction test:** If the S/h retains any shares in the company, it is a requirement that their holding be **substantially reduced**. This is done by taking 75% **x** % held pre POOS.

- ✓ **Assuming Gary retains the 250 shares:** Which **does not qualify** for capital treatment, the Co's share capital post buy-back will be **reduced from** **10,000** shares **to** **5,250** shares of which Gary and his wife will own **28.6%** as shown below:

	Shares held pre POOS	Shares bought back	Shares held post POOS
Gary and his wife	6,250	-4,750	1,500
Other	3,750		3,750
	10,000		5,250
Gary's combined %	62.5%		28.6%

- ✓ **Applying the 25% reduction test to Gary:** This is done by taking 75% **x** **62.5%** held pre POOS **=** **46.9%** i.e. this means the maximum number of shares Gary and his wife can held post POOS.

- ✓ **This condition is met:** Since the combined holding for Gary and his wife will be **28.6%** which is **<46.9%**.

>30% connection test

- ✓ **Scope:** Immediately after the purchase, Gary **must not be 'connected'** with the company i.e. where he owns **>30%** together with his associates of the following:

- Ordinary share capital;
- Loan capital and ordinary share capital; **and**
- Voting power

- ✓ **Share capital test:** Assuming that Gary retains **250 shares**, following the buyback Gary and Wendy will own **1,500** shares, which as noted is approximately **28.6%** of the reduced share capital and therefore **the 30% test is met**.

- ✓ **Loan capital test:**

- Wendy has a **credit balance** on her director's loan account (DLA) of **£30,000**.

- Since the **connection test** is by reference to the **combined** share/loan/voting capital held by Gary and Wendy their combined interests in the Co's loan and share capital would still **exceed** 30%.

- ✓ **Recommendation:** We would advise that her **credit balance** on DLA be **repaid to her** prior to the buyback.

Clearance application

- ✓ **An application for advance clearance:** May be made **to HMRC** before the buyback takes place.
- ✓ **HMRC will notify:** The Co that they **are satisfied** that the capital treatment is available.
- ✓ **The application:** Must be **in writing** and is usually in the form laid out in SP 2/82 (Company Purchase of Own Shares Help Sheet, Checklist A in this case) which also gives HMRC's further view regarding the trade benefit and other tests.
- ✓ **While the substantial reduction test may be met:** Where the Co is not buying the S/h's entire holding, HMRC consider that it is **unlikely** that the trade benefit test would be met.
- ✓ **HMRC guidance indicates:** That retention of a small shareholding for sentimental reasons, **not exceeding 5%**, would be acceptable.
- ✓ **Apply:** As the small holding retained by Gary of **250 shares** is **less than 5%** of the reduced share capital (**5,250 x** 5% **=** 262), this should **not prejudice** the trade benefit test and clearance is expected to be given.
- ✓ **The clearance application is made to:** HMRC's Clearance and Counteraction Team.
- ✓ **POOS return:** The Co must however still make a return of the buyback **giving details** of the payment and the reasons why the capital treatment is considered to apply (usually by attaching the clearance application and the clearance itself) **within 60 days** after the payment.

Example 5 – Past Paper Q – May 2018 – Prospects Developments Ltd

You are a tax manager working for a firm of Chartered Accountants. Your firm acts for a Prospect Developments Ltd, a house builder, and its shareholders. The partner responsible for the client is Joe Mills. The company and its shareholders are all UK resident. The Co has the y/e 31 October 2020.

The Managing Director and major shareholder, Steve Bishop (age 65), recently suffered a stroke. He is recovering, but is unable to carry out all of his former duties and has decided to retire from the company. In the past Steve has been the main driving force behind the company while his wife has concentrated on administration. His children are in their twenties and are keen to take over the business.

Steve acquired his shares on formation of the company in October 2006. The shares in the company are held as follows:

	£1 Ord
Steve Bishop	**45**
Laura Bishop (Steve's wife)	**15**
Michael Bishop (their son)	20
Leia Bishop (their daughter)	20
	100

The company's balance sheet as at 31 October 2020 was as follows:

	£	**£**
Fixed assets		
Leasehold property (the Co's premises)		200,000
Plant and machinery at NBV		150,000
Investment rental property		700,000
		1,050,000
Current assets		
Stock and work in progress	350,000	
Trade debtors	200,000	
Cash at bank	350,000	
Directors loan account (Steve)	**100,000**	
S.455 tax paid (Steve's loan)	25,000	1,025,000
		2,075,000
Current liabilities		
Trade creditors	325,000	
Bank overdraft	125,000	
Corporation tax	60,000	-510,000
Net current assets		1,565,000
Amounts falling due after more than one year (bank loan)		-550,000
Net assets less liabilities		**1,015,000**
Capital and reserves		
Called up share capital		100
Profit and loss account		1,014,900
Shareholders' funds		**1,015,000**

The company's Total Taxable Profit consisted of £255,000 trading profit and £45,000 profit from a UK property business.

Steve has discussed his withdrawal from the business with Joe Mills. He proposes that the company purchase his shares for **£500,000**, which is considered to be an arm's length price. The company does not have the cash available to purchase all Steve's shares so it has been suggested that the company buy back half his shares now for £250,000, which will be paid in cash on completion of the buy-back. Steve is a higher rate taxpayer.

Given Steve's knowledge of the business he would like to remain as a director or consultant to the company and the intention is that after six months the company will purchase the remaining half of his shares under a separate contract for £250,000. If necessary, funds would be raised by selling the investment property.

The conditions for Business Asset Disposal Relief (BADR) to be available are met but Joe is uncertain as to whether capital treatment would be available. Steve is quite flexible over the timing of his retirement and the sale of his shares and would like your firm's suggestions as to what steps would be required to achieve the optimum tax treatment.

Steve could repay his director's loan as soon as he receives the cash for his shares but has asked whether he would be better to do that or whether it would be preferable for the company to formally write-off the loan and for him to accept £400,000 for his shares.

You are required to write a memo to Joe Mills advising on the tax implications of Steve's proposals and on optimising the tax position for Steve and the company.

Total 15 Marks

Answer

To:
From:
Client:
Subject: Proposals for company purchase of own shares etc.

Joe Mills
A Tax Manager

Prospect Developments Limited / Steve Bishop

Introduction

- ✓ **Articles must permit:** A company purchase of own shares (POOS) must be **permitted** by the Co's articles of association.

- ✓ **Tax impact for the S/h:** It is regarded as a **distribution** and taxed as a dividend for income tax purposes **unless** the capital conditions are met.

- ✓ **CGT BADR:** I understand that Steve would qualify for CGT BADR but agree with your advice that Steve's proposals in their existing form would not meet those requirements for the reasons outlined below.

Conditions for the Co

- ✓ **Co type:** The Co is an **unquoted trading Co**.

- ✓ **Co owns an investment property:** With a balance sheet value of **£700,000**, the test of a trading Co is one whose business consists **wholly or mainly** of carrying on a trade i.e**. >50%,** which seems clearly the case. This is because the **non-trading element** is <50% i.e. **£700,000 / £2,075,000 = 34%**.

- ✓ **Benefit the Co's trade:** The POOS **must be** for the purpose of benefiting the Co's trade.

- ✓ **Apply:** Steve is **unable** to carry out all of his former duties and **it will benefit** the Co's trade for his children to take over those functions, who are also keen to do so.

- ✓ **HMRC guidance:** Gives an example of the 'trade benefit' test being met where a controlling shareholder wishes to **retire** to make way for new management.

- ✓ **A second condition**: Is that the POOS **must not be to enable** the owner of the shares to participate in the profits of the Co **without** receiving a dividend.

- ✓ **Problem: Steve's intention to remain as a director** is however problematic and may call into question whether it is for the benefit of the trade for him to retire if his services are still required.

- ✓ **Tax avoidance:** It is clear from the facts, that the proposed transaction **has not been designed** to avoid tax.

Conditions for Steve

- ✓ **The seller must be UK resident:** In the **tax year** in which the POOS is made.

- ✓ **Ownership rule:** The shares must have been held for **at least** 5 years.

- ✓ **Apply:** This test is met. **5 year ownership** requirement.

Substantial % reduction test

- ✓ **25% reduction test:** If the shareholder retains any shares in the Co, it is a requirement that their holding be **substantially reduced** by taking 75% **x** % held pre POOS.

- ✓ **Include associates:** The combined interests of the seller and the seller's associates subsequently must not be more than 75% of their prior interests.

- ✓ **Apply:** Steve's wife is **included** an associate for this purpose **but not** his adult children as they are **over 18**.

	Shares held pre POOS	Shares bought back	Shares held post POOS
Steve and his wife (45 + 15)	60	-22	38
Michael Bishop	20		20
Leia Bishop	20		20
	100		78
Steve's combined %	60%		48%

- ✓ **Their combined holdings:** Steve and Laura's shareholdings before the POOS represent a combined interest of **60%** in the Co so their combined interests must reduce to below **60% x** 75% **= 45%** i.e. max combined % that can be held post POOS.

- ✓ **If the company buys 22 of Steve's shares (being half of his holding):**

- **The issued capital of the Co:** Would **reduce** to **78** shares.

- **Steve and Laura:** Would own **38** of those shares i.e. a **48%** interest post POOS.

- **The substantial reduction test:** Is not met **because** the **48%** holding is **>45%** under the substantial reduction test.

>30% connection test

- ✓ **Scope:** Immediately after the purchase, Steve must not be **'connected'** with the company i.e. where he owns **>30%** of the Co together with their associates:

- Ordinary share capital;
- Loan capital and ordinary share capital; and
- Voting power

- ✓ **Share capital test:** As Steve and Laura would still own **48%** of the issued capital after the first leg of the POOS Steve would **remain connected** with the company.

Recommendation

- ✓ **Carry out the POOS as one transaction:** For the purchase of the **whole of Steve's holding**, as soon as the Co is able to raise the funds to do so.

	Shares held pre POOS	Shares bought back	Shares held post POOS
Steve and his wife (45 + 15)	**60**	**-45**	**15**
Michael Bishop	**20**		**20**
Leia Bishop	**20**		**20**
	100		**55**
Steve's combined %	**60%**		**27%**

- ✓ **Laura would still retain 15 shares:**
- Out of a **reduced issued capital** of **55** shares i.e. an interest of **27%**.
- This would **meet** the substantial reduction test. Since **27%** is <**45%** i.e. the % held pre POOS **60% x** 75%.
- ✓ **Steve should retire as a director:** On completion of the POOS **for the purposes** of the trade benefit test.

Clearance application

- ✓ **An application for advance clearance:** May be **made to HMRC** before the buyback takes place. whereby
- ✓ **HMRC will notify:** The Co that they are **satisfied** that the capital treatment is available.
- ✓ **The application:** Must be **in writing** and is usually in the **form laid out** in SP 2/82 (Company Purchase of Own Shares Help Sheet, Checklist A in this case) which also gives HMRC's further view regarding the trade benefit and other tests.
- ✓ **The clearance application is made to:** HMRC's Clearance and Counteraction Team.
- ✓ **POOS return:** The Co must however still **make a return** of the buyback giving details of the payment and the reasons why the capital treatment is considered to apply (usually by attaching the clearance application and the clearance itself) within 60 days after the payment.

Steve's overdrawn loan account of £100,000

- ✓ **Dealing with the loan:** Steve repays this out of the proceeds of the POOS **or** this is written off.
- ✓ **Impact on the Co:** The Company will be able to **recover** the **£32,500** (32.5% penalty tax **x** **£100,000**) paid 9 months and 1 day after the accounting period in which the repayment/write-off takes place.
- ✓ **Apply:** As the Co's year-end is 31 October that would be nine months **+** 1 day after 31 October 2020 i.e. on 1 July 2021.
- ✓ **If the Co writes-off or releases the debt:** Steve would be liable to **income tax** at the **dividend tax rates**. Steve's liability at 32.5% would be **£32,500** (or more if the additional income brings him within the additional rate at 38.1%).
- ✓ **Class 1 secondary NIC re loan waiver:** HMRC regard the release of a loan to an employee as **earnings** for national insurance purposes and the company may therefore be required to pay NICs of **£100,000 x** 13.8% **=** £13,800.
- ✓ **My advice:** Is therefore for Steve to **repay** his loan account as soon as he **receives the cash** for his shares to **avoid** the additional income tax **and** Class 1 Primary NIC charge.

Example 6 – Past Paper Q – Roger Green

Roger Green owns **100 ordinary shares of £1** each in Buildco Ltd a close trading company of which he is also a full time working director. The company has been run together with his four brothers who each own 100 shares. Roger has had a serious disagreement with his brothers concerning the management of the company and they are now discussing an exit strategy for Roger.

Roger and his brothers set up the company in 1995 subscribing for the shares at par value. The company currently has reserves on its balance sheet of £1 million.

His brothers have offered two possible deals and would like the exit strategy to be agreed by January 2021 in order to minimise the disruption to the business. Roger has asked your tax partner for advice regarding the tax consequences of each of the proposed deals.

Roger is an additional rate taxpayer and uses his CGT annual exempt amount every year to cover gains on his quoted share portfolio. He is dividend allowance has also been allocated to dividends received in the tax year arising from his portfolio.

The possible deals are:

(1) The company purchases the whole of Roger's shareholding for **£250,000** (which is the market value of the shares).

(2) The company purchases 60 of the shares for **£100,000**. This is the agreed market value of the shareholding.

Answer – Deal 1 – Acquire all of Roger's shares

Conditions for the Co

- ✓ **Co type:** The Co is an **unquoted trading Co**.
- ✓ **Benefit the Co's trade:** The POOS **must be** for the purpose of benefiting the Co's trade.
- ✓ **Apply:** HMRC take the view that a **dissenting S/h** should be **fully removed** in order that the transaction fulfils the 'benefit to the trade' test. This condition is met.
- ✓ **Tax avoidance:** It is clear from the facts, that the proposed transaction **has not been designed** to avoid tax.

Conditions for Roger

- ✓ **UK resident:** He is UK resident in the **tax year** in which the POOS is made.
- ✓ **Ownership rule:** He has held the **entire holding** for **5 years**.

Substantial % reduction test

- ✓ **25% reduction test:** If the shareholder retains any shares in the Co, it is a requirement that their holding be **substantially reduced** by taking 75% **x** % held pre POOS.
- ✓ **Include associates:** The combined interests of the seller and the seller's associates subsequently must not be more than 75% of their prior interests. His brothers are **not associated** for this purpose.
- ✓ **Apply:** This test is met since **all of Roger's shares** are being bought back by the Co.

>30% connection test

- ✓ **Scope:** Immediately after the purchase, Roger must not be **'connected'** with the company i.e. where he owns **>30%** of the Co together with their associates:

- Ordinary share capital;
- Loan capital and ordinary share capital; and
- Voting power

- ✓ **Apply:** This test is met since **all of Roger's shares** are being bought back by the Co.

Clearance application

- ✓ **An application for advance clearance:** May be made **to HMRC** before the buyback takes place.
- ✓ **HMRC will notify:** The Co that they **are satisfied** that the capital treatment is available.
- ✓ **The application:** Must be **in writing** and is usually in the form laid out in SP 2/82 (Company Purchase of Own Shares Help Sheet, Checklist A in this case) which also gives HMRC's further view regarding the trade benefit and other tests.
- ✓ **The clearance application is made to:** HMRC's Clearance and Counteraction Team.
- ✓ **POOS return:** The Co must however still make a return of the buyback **giving details** of the payment and the reasons why the capital treatment is considered to apply (usually by attaching the clearance application and the clearance itself) within 60 days after the payment.

Answer – Deal 2 – Acquire 60 of Roger's shares

Key points

	Shares held pre POOS	Shares bought back	Shares held post POOS
Roger	100	-60	40
4 brothers	400		400
	500		440
Roger's %	20%		9%

- ✓ **Problem:** HMRC will **block** the capital treatment because Roger as a dissenting S/h will continue to retain a shareholding in the Co despite the following **being met**:
- **Substantial reduction test:** Since 9% is <15% i.e. the % held pre POOS 20% x 75%.
- **Connected test:** Since 9% is <30%.
- ✓ **Benefit the Co's trade:** The POOS **will not be** for the purpose of benefiting the Co's trade.
- ✓ **Tax impact for Roger:** The capital conditions are **not met**, the payment by the Co for the shares will be taxed as an income distribution subject to the **dividend allowance** of £2,000 and **dividend rates** of income tax.
- ✓ **Original subscriber:** Since Roger is the original subscriber, he will able to **deduct his own base cost** when computing the dividend.

Capital treatment:	£	Income treatment:	£
SP	250,000	SP	100,000
Less cost 100 shares	-100	Less cost 60 shares	-60
Gain	249,900	Dividend	99,940
CGT 10% BADR	24,990	Income tax 38.1%	38,077

- ✓ **Recommendation:** Roger should **accept deal 1** as this achieves the **lowest tax charge**.