fact sheet

Share Buy-Backs

everymanlegal
dedicated to business growth

Preliminary

The need for a share buy-back often arises when a Director or employee-shareholder ceases to be employed. Rarely will it be appropriate for the departing individual to continue to hold the shares.

The first thing to do is to check the Articles of Association and any Shareholders' Agreement. You will be looking for a clause that triggers the right for the shares held to be reacquired: corporate solicitors call this a "call option" or a "buyback" clause.

The call option or buy-back will usually create a right for the continuing shareholders to buy the shares often at a price fixed by a third party valuer. Sometimes the Articles or Shareholders' Agreement will enable the company itself to buy-back the shares and cancel them. See the Everyman Fact Sheet on Shareholders' Agreements.

Often there will be no Shareholders' Agreement or call option/buy-back clause in the Articles. Then it will be a matter of negotiation. If there is no such clause, the owner-manager may be well advised to ensure that the negotiations on termination of employment include agreement as to the purchase of the shares.

This Fact Sheet is concerned with the commercial, tax and legal issues associated with a share buy-back by the company in contrast to a purchase of shares by other shareholders.

Why a share buy-back is useful – tax position of the company

It is often the case with owner-managers that all their wealth is tied up in their company. Taking money out of the company (to use it to buy the shares of the departing employee), even as a dividend, will currently cost 7.5%, 32.5% or 38.1% depending on your rate of income tax. The first £2,000 of dividend income is currently exempt from tax (having dropped from £5,000 with effect from 6 April 2018 to 5 April 2019.

The advantage of the share buy-back is that the company's own funds can be used to fund the purchase and no tax arises for the owner-manager or the company, except for any stamp duty payable when the ownership of the shares is transferred.

What about the tax position of the selling employee?

The starting position is that the increase in the value of the shares (above their original subscription price) is subject to income tax as if it were an ordinary dividend.

However, if the employee-shareholder has owned the shares for at least 5 years and their shareholding is "substantially" reducing, then any gain on the shares may qualify for capital gains tax treatment at 20% or 10% if Entrepreneur's Relief is available. The annual CGT exemption of £11,700 will also be available.

To obtain the capital gains treatment the company must be an unquoted trading company. A HM Revenue & Customs clearance procedure is available and if such treatment is to apply (whether or not clearance is obtained) the Company must notify HMRC within 60 days of the buy-back.

The transaction must be for the benefit of the company (for example if the owners have fallen out). TO meet this requirement HMRC requires all shares to be sold but retention of a small token shareholding may be permitted.

Entrepreneur's Relief applies to shares owned for at least 12 months where the Director/employee holds at least 5% of the equity. The relief is not available if the person concerned has ceased to be a Director or employee more than 12 months before the sale.

What are the legal mechanics?

A resolution of the shareholders to approve the buy-back must be obtained and a share buy-back agreement which can be a simple contract will record the transaction. The resolution requires eligible members who hold more than 50% of the issued shares to approve the transaction. It should be noted that a member holding shares to which the resolution relates is not an eligible member and therefore cannot vote on the resolution.

The buy-back agreement can either be approved by a resolution prior to the company entering into it, or the buy-back agreement can state that no shares may be purchased under the agreement until its terms have been approved by resolution.

There is a more complicated procedure (see below) if the purchase price cannot be met from "distributable reserves" (that is the accumulated profits as shown in the accounts).

A form SH03 (available from http://www.companieshouse.gov.uk/) along with a copy of the written resolution must be filed at Companies House within 28 days. Stamp duty of 0.5% is payable on the purchase price if it exceeds £1,000, in which case the form will need to be sent to HMRC for stamping prior to filing it at Companies House.

A form SH06 must also be filed at Companies House where the shares have been purchased for cancellation. This form includes a revised statement of capital. The alternative to cancelling shares is to hold them in treasury.

What else should be done?

You will need to arrange for the Register of Members (which is part of the Company's statutory books) to be updated: your accountants or your solicitors may hold these for you. Where shares have been purchased for cancellation, the shares are cancelled at the time of the buy-back.

Where applicable (i.e. if the buy-back will give rise to an income receipt) the Company should issue to the shareholder a tax voucher.

What if the price cannot be met out of profits?

Payment of the purchase price under a company buy-back must be made at the time of the purchase, so deferred payments and instalments are not permitted (but see below).

If the purchase price exceeds the available distributable reserves then an additional procedure to buy the shares back out of funds raised through a new issue of shares, or out of capital must be followed. The latter is only available to private companies not to public companies.

The procedures for a buy-back out of capital are designed to protect the creditors of a company. The Directors must make a statement backed up by the company's auditors as to the company's solvency at the time of the buy-back and for the following 12 months. An advertisement must be filed in a publication called The London Gazette. The buy-back cannot be made sooner than 5 weeks nor later than 7 weeks from the date of the shareholders' resolution.

However, there are exceptions to these requirements:

De Minimis
If a Company's Articles of Association include express authority to do so, a Company may purchase its own shares out of capital up to a maximum purchase price in any financial year of the lower of £15,000 or the nominal value of 5% of its paid up share capital at the beginning of the financial year in which the buy-back is proposed.

Employee Share Schemes
The Buyback Regulations 2013 introduced provisions in relation to a company buy-back for the purposes of or pursuant to an employee share scheme. These provisions allow for a simplified process for a purchase out of capital involving a special resolution and solvency statement (without the need for a directors' statement, auditor's report or public notice). In addition, payment for the shares can be made by the company after the buy-back and/or in instalments.

Do you need more information?

For more information, contact:

James Hunt

Location: Oxfordshire
Direct Dial: 01993 893622
Email: james.hunt@everymanlegal.com

Nicola Blackford

Location: Oxfordshire
Direct Dial: 01993 893624
Email: nicola.blackford@everymanlegal.com

Gail Vallis

Location: Oxfordshire
Direct Dial: 01993 893968
Email: gail.vallis@everymanlegal.com

Natalie Hopkins

Location: Oxfordshire
Direct Dial: 01993 893626
Email: natalie.hopkins@everymanlegal.com

© Everyman Legal Limited 2012 - 2019

Important Notice

This memorandum is designed to provide a general commentary on aspects of the subject matter covered. It does not purport to be comprehensive or render legal advice. Everyman Legal Limited and the author expressly disclaims any liability in respect of the consequences resulting from acting or refraining from acting on the basis of any matter contained in this publication.

All rights are reserved