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Dear Mr Pattison

PURCHASE OF OWN SHARES

I attach for information a copy of a consultative paper on the tax treatment of companies purchasing their own shares. This was foreshadowed in the Chancellor's Budget speech (Hansard, 10 March 1981, Col 780). The Revenue hopes to publish the paper tomorrow or on Monday.

W. J. Simon
M. C. Felstead
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Print Secretary

COMPANIES PURCHASING THEIR OWN SHARES

IMPLICATIONS FOR CORPORATION TAX, INCOME TAX AND CAPITAL GAINS TAX

PART I : THE ISSUES FOR DISCUSSION

A. INTRODUCTION

Proposed changes in company law

1. The Companies (No 2) Bill currently before Parliament contains provisions enabling companies, if authorised by their Articles, to purchase their own shares and to issue redeemable shares, subject to certain safeguards. In general, shares may only be purchased or redeemed out of distributable profit or the proceeds of a fresh issue; but there are certain further provisions for private companies. A summary of the proposals in the Companies (No 2) Bill is at Annex I.

Background

2. These proposals in the Companies (No 2) Bill follow the issue of a Green Paper in June 1980 by the Secretary of State for Trade. In paragraph 11 of that Green Paper the then Secretary of State said:

"Treasury Ministers will be considering in a separate review the case for easing the tax charge in certain classes of case, where this could help to make possible a desirable increase in the flexibility of company organisation."

Purpose of the consultative paper

3. This consultative paper accordingly discusses possible changes in the tax treatment of certain payments made by companies when purchasing etc their own shares, and whether

such payments should be exempt from the present tax provisions dealing with distributions of profits (involving liability to advance corporation tax and income tax), and should be left to be handled under the rules for capital gains tax.*

4. It concentrates in the first instance on the main case, where shares are purchased or redeemed out of distributable profits. A subsequent section (paragraphs 39 to 46) discusses the question whether a distinction should be made between that case and the case where shares are purchased or redeemed out of capital.

B. IMPLICATIONS FOR TAX

Existing legislation

5. The existing rule for tax is broadly that, when a company distributes profits to its shareholders, the distribution is treated as a payment of income by that company and a receipt of income by the shareholders. Thus, the company pays advance corporation tax (ACT) and the distribution is taxed as income (with a tax credit attached) in the hands of the shareholders.

6. This rule applies both generally, and in the special situation when under existing tax law a company uses surplus profits** to purchase its own shares (as certain kinds of companies already can, even under the existing companies legislation). By contrast, in normal circumstances when a capital asset such as an equity share is sold and bought, any gain in the hands of the seller - generally the difference between what he pays and what he gets - is subject to tax under the capital gains tax rules.

* The paper does not discuss other more technical changes in tax legislation which may need to be considered in the light of the new companies legislation.

**Excluding amounts representing the return of the original capital.

7. This difference of treatment follows from the difference in the nature of the two transactions, as they relate to the structure of company taxation:

a. In the former case, it is of the essence of the thing that profits pass out from the company to the shareholder concerned.

b. In the latter case, there is a transfer of a valuable capital asset between one (old) shareholder and another (new) shareholder; and no profits pass out from the corporate sector.

8. Conversely, in the latter case there is a reduction in the (old) shareholder's interest in the company; this may or may not be so in the former case.*

9. It depends on the circumstances and status of the various shareholders (whether for example they are individuals or companies) whether the former treatment implies a larger or a smaller tax bill than the latter.

10. The general principle underlying this treatment is that the same consequences should follow, whenever a continuing company distributes profits to its shareholders, irrespective of the form which the distribution takes.

*The obvious limiting case is the one-man company:

a. if the company purchases 50 per cent of his shares, he remains the 100 per cent owner of the company; but he has cash which was previously held by the company

b. if someone else purchases 50 per cent of his shares, he ends up with only a half interest in the company; and the company has paid out none of its accumulated cash.

The same effects obviously apply, *mutatis mutandis*, where shares are more widely held.

C. SCOPE OF THE GOVERNMENT'S PROPOSALS

11. For the reasons outlined in paragraphs 7 to 10 above - and because of the possible implications for the present yield of tax on dividends of some fm500* - the Government see no case for simply substituting capital gains tax treatment for the present tax treatment in all cases where a company purchases its own shares; in particular, in cases where the main object of a company doing so is to distribute surplus profits to its shareholders.

12. On the other hand, the Government believe that in certain situations a change in the present tax treatment can add significantly to the new flexibility proposed in this year's Companies Bill. In introducing his "enterprise" measures to help small firms, in this year's Budget Statement, the Chancellor of the Exchequer said:

"As the House know, the Government will shortly introduce new clauses in Committee on the Companies Bill, to enable companies to purchase their own shares. Corresponding changes are needed in the present tax structure to help with a number of problems arising in small and family businesses. I am, therefore, asking the Inland Revenue to issue a consultative document on this subject this summer, with a view to legislation in next year's Finance Bill."**

* This takes account only of those dividends to shareholders who could benefit from a change in tax treatment. Most corporate and some other shareholders would probably prefer the present tax treatment to having any gain on disposal made subject to the capital gains tax rules.

**Official Report 10 May 1981, column 780.

D. CHANGES AFFECTING CERTAIN CLASSES OF CASE

13. The issue discussed in this consultative document is how to define the "certain classes of case" referred to in the 1980 Green Paper,* and further developed in the 1981 Budget Statement,** where the present tax treatment should be changed.

14. The new legislation for this purpose may have to address itself to more difficult questions than the present legislation on distributions. The present provisions*** look to the relatively simple question: is there a distribution of profits? The new legislation may have to go on to ask: if so, in what circumstances and for what purpose is the distribution being made?****

15. It is implicit in the fact that this consultative document is being published, that the Government believe that the benefits of greater flexibility in this area will in certain important instances be sufficient to outweigh this extra complexity. So far as possible, however, tax rules need to be both simple and certain in operation. In each case at the margin it will be necessary to balance the economic advantages of greater flexibility against the economic costs of possible distortion or avoidance, and of complicating an already complex system of business taxation.

16. Thus, in considering possible specific suggestions for change, 4 main questions may arise:

- a. What reasonably clear economic or commercial benefit would follow from a change in the tax rules?

* See paragraph 2 above.

** See paragraph 12 above.

*** Part X and Section 284 of the Taxes Act 1980.

**** In this respect, it will be moving into the kind of field (though not of course precisely the same field) which is presently the concern of Section 460 of the Taxes Act.

b. Is this benefit reasonably clearly distinguishable from the general benefits when a company pays out surplus profits to its shareholders?

c. Is the case capable of being defined reasonably clearly in legislation?

d. Could it be recognised reasonably clearly in practice?

17. The Government's purpose, in issuing this document, is to expose the issues for public discussion, and to invite comments which will help them to decide the form in which, should a consensus emerge, they should bring forward legislation in the 1982 Finance Bill.

18. The consultative document seeks at this stage to concentrate on the broad issues for discussion, leaving aside for the time being most of the technical details with which any legislation would have to deal. But the Government would, of course be glad to receive comments or suggestions on any aspects of a possible change.

19. Where it is possible to arrive at a reasonably clear and workable definition of special "classes of case" for the purposes of this legislation, the question will arise whether it is necessary, or desirable, to restrict the special tax treatment to the occasions when a company purchases its own shares. The question could arise whether the same treatment should be extended to the cases where, in similar underlying circumstances, the company finds it preferable on broad commercial grounds to redeem shares or to reduce share capital in the course of a company reconstruction. This again is a matter on which the Government will welcome comments.

PART II : IMPLICATIONS FOR POSSIBLE NEW LEGISLATION

E. POSSIBLE AREAS FOR SPECIAL TAX TREATMENT

20. The 1980 Green Paper sought to list* the main advantages which had been suggested for allowing companies to buy their own shares; but the Government would, of course, be ready to consider other suggestions. The Green Paper emphasised that the case for changes in company law stood independently of any changes in tax law.

21. Some of the possible objectives listed in the Green Paper are not within the intention of the new companies legislation (for example, the opportunity for a company to make money by trading in its own shares). Others are relevant to the general tax treatment of distribution of profits, rather than to the special case when a company purchases its own shares (for example, to provide a company which has surplus cash with a further means of using it to the advantage of its shareholders.**)

22. An example of the latter is perhaps the case where a share purchase could result in a company's shareholders retaining something close to their ex ante percentage shareholding in the company, or where shares are purchased^{ab} from a dominant shareholder or group of shareholders who retain ex post a dominant interest in the company. In these kinds of case it appears reasonably clear that the effect of the share purchase is essentially equivalent to a dividend or distribution of profit.

23. In other cases again, the existing tax rules are no obstacle to the aim identified in the 1980 Green Paper (for

* Cmnd 7944, in particular paragraphs 11 and following.

**See paragraphs ~~8~~¹¹ and ~~14~~ to ~~18~~ above.

example, in the straightforward case* where a company buys up redeemable preference shares before redemption, at a time when they are quoted at below the redemption price).

24. However, experience over the past decade or so and the response to the 1980 Green Paper suggest that 5 main types of situation are thought to stand out, where a change in the tax treatment, when a company purchases its own shares, could help certain kinds of trading businesses to manage their affairs more flexibly and efficiently:

- First, the facility could encourage people to buy the company's shares. As things stand, outside investors can be reluctant to invest in the equity of the kind of business for whose shares there is no ready market, and the potential investor can be reluctant to accept the risk of being "locked in".
- Second, it could make it easier for the proprietor of a business to seek equity investment from others. In some cases, an entrepreneur can be unwilling to surrender a permanent equity stake.
- Third, it may contribute to the efficient management of the business, if dissident or apathetic shareholders can be bought out. Again, in some cases there may be no ready market for the shares in question, and the other shareholder or shareholders may not have sufficient free capital to buy out the dissenting interest.
- Fourth, when a family shareholder with a significant number of shares retires or dies (and there are no children to succeed him), the other members of the family may not be able to afford to buy out his shares. There may be cases where the only option is to sell shares to a third party and - where this results in loss of family control - it could have harmful effects on the company's trade.

*There is in general no income tax charge when a company purchases or redeems shares at a price equal to less than the price at which they were issued.

- Fifth, a very similar situation can in principle arise when the shareholder dies, and there is no alternative to the estate selling shares, if CTT liabilities are to be met.

25. The Government would welcome comments on these five situations. How far are they themselves important for the efficient and flexible management of a trading business? And how far do they cover the main areas of potential benefit?

F. POSSIBLE NEW LEGISLATIVE PROVISIONS

26. It would be premature to draft specific new legislative proposals in advance of public comment on the questions raised in Section E and paragraph 25 above. But two approaches seem to merit consideration.

(Old para. 27 deleted)
27. One approach might be to seek to define each of the "special classes of case" individually. On the face of it, this could present difficulty. To take only 3 examples, how in practice would one define the "reluctant investor" (the first case in paragraph 24 above), the "unwilling proprietor" (the second case), or the "dissident shareholder" (the third case) for the purposes of a taxing statute?

28. A more promising approach might be to look for common features, which the legislation could use in a more general way to identify the "special classes of case" for which it was desired to change the present tax ^{treatment} ~~system~~, and to distinguish them from other cases where the effect of a company purchasing its own shares would predominantly be a distribution or paying out of surplus profit.

29. It may be helpful to illustrate an approach of this kind in terms of the 5 main types of case listed in paragraph 24 above. It may be thought that they are trading business which have 3 main features in common.

30. First, they are all cases which arise because the shares of the company in question are closely held and/or where there is no ready market in which a shareholder can be confident of selling a possible minority shareholding, when he wishes, at a fair price. By contrast, shares quoted on the Stock Exchange, may be sold fairly readily - though obviously the price which shares fetch at any time may be affected by such things as the size of the shareholding and by current market conditions.

31. In general, it may be felt therefore* that these are essentially problems for the unquoted company, as distinct from the company whose shares are widely held and quoted on the Stock Exchange. The Government would welcome views, in the light of any comments expressed on Section E above, whether this might represent one possible criterion for new legislation. If so, it would be for consideration whether the distinction should be between public and private companies, or between "quoted" and "unquoted". If the latter, it would also be for consideration how to treat shares of companies quoted on the Unlisted Securities Market and on the over-the-counter "Nightingale" market. It is not clear how relevant the former would be.

32. Second, they all seem to be cases in which the shareholder parts with his interest in the company, either by selling his shares, or on death. This itself may tend naturally (in the case of the more narrowly held and unquoted company) to distinguish cases of this kind from the cases (cf paragraph ²²~~24~~ above) where the effect of a company purchasing its own shares is evidently equivalent to a dividend or a distribution of surplus profits.

33. It may also be that, when a shareholder and his associates cease to have any interest in the company, there is substantially less risk that a tax easement will be misused.

*cf the 1981 Budget Statement, paragraph 12 above.

34. The Government would therefore welcome views whether it might be a further criterion of new tax legislation, that the shareholder whose shares are being purchased should part with his interest in the company.

35. If so, consideration would need to be given to the definition of "parting with a shareholder's interest". As it stands, the implication is that the shareholder should part with the whole of his interest. This would seem likely to be the most simple approach, both legislatively and administratively (see paragraph ³²~~34~~ above). Would there be major problems with this approach, or would there be major commercial difficulties if the legislation did not provide for the more complicated situation where the shareholder may very substantially reduce his percentage shareholding in the company, but still retain a very much reduced (and not dominant) interest?

36. Consideration would also need to be given to the detailed provisions necessary (for example) to identify the genuine case where an investor has held his shares for some minimum period (say normally 5 years) before the share purchase (as distinct from the case where, perhaps, some person moves in just long enough to strip out surplus profits), and also to provide for the case where the investor maintains or reacquires an effective interest in the company subsequent to the share purchase (for example, by retaining an option to re-purchase his shares after the event, or by maintaining an interest in the hands of his close associates or through companies under his control).

37. Third, the cases in paragraph 24 seem to relate mainly, if not wholly, to investment by individuals resident in the UK. To introduce special rules for the taxation of purchases of shares held by shareholders other than individuals would seem likely to raise significant new complications.* To extend the same

*and could also be generally to the shareholder's disadvantage - see paragraph ⁹ above. Corporate shareholders - and the related problem of shareholdings held by nominees are most common in - though by no means exclusive to - quoted companies.

treatment to non-resident shareholders would raise different issues, to the extent that the proceeds of the share purchase or redemption would not generally be subject to the alternative charge to capital gains tax, and the profit distribution would therefore be free of all UK tax. The Government would welcome comments on the implications for these further categories of cases.

38. Clearly, no one of the three common features listed above would be sufficient, by itself, to distinguish the "classes of case" which might qualify for the proposed new relief from other cases where the existing rules should apply. Thus, for example,

a. Obviously an unquoted company may use a share purchase or redemption to distribute accumulated profits to its shareholders.

b. In the case of a quoted company whose shares are widely held, it may be that there is a less helpful distinction between buying out all of some shareholdings,* as against buying out some of all shareholdings. In each case the substance of the matter may be that the company makes a profit distribution equal to a given percentage of the equity capital.

The Government would however welcome comments on how far the three common features discussed in these paragraphs might go to form the basis of a rule for distinguishing certain classes of case for the proposed relief, when taken together.

*Shares which are sold receive accumulated profits from the company; shares which are not sold may (as explained in page 10 of the 1980 Green Paper) become more attractive investments for that reason. This note does not deal with the question whether in this kind of case the rules of the Stock Exchange and the Companies Acts provisions in relation to insider trading are likely to require such a company making any substantial purchase of its own shares to give all shareholders an opportunity to benefit equally. Nor does it deal with the other practical implications that will arise in this area, irrespective of any changes of the kind discussed in these paragraphs.

(Some technical points of company law are still being checked in the paragraphs) c. for

G. ALIGNMENT OF TAX LAW WITH COMPANY LAW

39. The preceding sections of this note have discussed the question whether in "certain classes of case" the capital gains tax rules (not ACT and income tax) might apply. There is a more radical question whether, in cases of repurchase or redemption of shares, the basic tax rules should be restructured to follow the new company law rules.

40. As tax law now stands, the basic rule (elaborated in several pages of other legislation dealing with bonus issues, company reconstructions etc) is that only the excess over the repayment of the original capital subscribed is treated as a distribution, and liable to ACT and income tax accordingly.

41. In the main case, the new Companies Bill may be thought consistent with this. Clause 43(5) (b) of the Bill provides that ~~any payment of this excess~~ ("any premium payable on redemption"*) must normally be paid out of distributable profits. This applies even where the repurchase is being effected out of the proceeds of a fresh issue of capital. A "premium" in Companies Bill terms however is always the excess over the nominal value, which may not be the same as the excess over the amount subscribed.

42. The Bill goes on however to make 2 exceptions. The first applies where the shares being repurchased were themselves issued at a premium (Clause 43(6)). In that case, "any premium payable on their redemption" may be paid out of the proceeds of a fresh issue of shares made for the purpose up to the lesser of the premiums originally received by the company on the shares of which some are being repurchased and the current amount of the company's share premium account including any premium on the new shares. So far as "any premium payable on their redemption" can include a premium in excess of the

*The same rules apply for repurchase as apply for redemption.

premium at which the shares were issued, this is a case in which the excess over the subscription price may be paid out of capital (though not so as to effect a net reduction in capital reserves).

43. The second exception (Clause ⁵⁰~~49~~) is where the repurchase is effected out of existing capital; this is allowed in the case of a private company whose Articles so provide after it has exhausted available profits and the proceeds of any fresh issue.

44. The question arises whether as a general rule, the tax provisions should be radically restructured in line with the new proposals in the Companies Bill so that (a) where shares are redeemed or repurchased (but not otherwise) any part of the excess over the original subscription price which was treated under company law as paid out of share premium account or out of capital would not be treated as a distribution of profits; (b) where company law treats the whole of the repurchase price as paid out of distributable profits, the whole should likewise be treated for tax purposes as a distribution (and not, as now, only the excess over the amount subscribed).

45. In either case, the new rule would not apply in the "certain classes of case" discussed in paragraphs 20 to 38 above. In those cases, irrespective of the company law treatment, the whole payment would be brought in for purposes of capital gains tax as consideration for the disposal of the shares.

46. The Government would welcome comments on this more radical approach. If it is thought to have merit, the Government would also welcome comments on the implications for associated areas of tax treatment, in particular:

- a. for the consequence that a different tax liability would follow, where on the one hand a company redeemed its shares under the new proposals in the Companies Bill,

and on the other hand, the company made use of the existing provisions to go to the Courts for a reduction in share capital; and

b. for the consequences if new shares issued to finance a share purchase or redemption were themselves subsequently purchased, redeemed or otherwise repaid. The logic of the proposals seems to require that they should in effect be treated as "standing in the shoes" of the shares whose place they have taken; that is, as if the amount of new capital subscribed for those shares should (where necessary) be treated as reduced or increased to equal the amount of new capital subscribed for the original shares.

H. SUMMARY

47. The Government invite comments on the case for exempting from advance corporation tax and income tax payments made in certain defined classes of situation by companies when purchasing their own shares, leaving these to be handled under the rules for capital gains tax (paragraphs 17 and 18). The Government also invite comments on whether, if it is possible to arrive at a reasonably clear and workable definition of such "classes of case", it would be necessary or desirable to restrict special tax treatment to the occasions when a company purchases its own shares, or whether the same treatment should be extended to the cases where, in similar underlying circumstances, the company finds it preferable on broad commercial grounds to redeem shares or to reduce share capital (paragraph 19).

48. On specific points discussed in this consultative document, the Government invite comments on:

a. The extent to which the 5 main types of situation discussed in paragraph 24 cover the main areas where a change of tax treatment would be of potential benefit to trading businesses - in a way which could clearly be

distinguished from the general benefit such businesses might expect to derive from an easing of the tax charge on distributions of profit; or whether there are other comparably important areas of potential benefit (paragraph 25).

b. Whether a helpful common feature - in identifying cases of this kind and distinguishing them from the cases where the purchase of own shares might more commonly be equivalent in effect to a distribution of profit or dividend - might have reference to the facts that the companies making the payments in question are private or unquoted, and that the people receiving the payments are UK resident individuals who are parting with their interests in the company and consequential points of detailed interpretation (paragraphs 31 to 38).

c. Whether there is a case for any more radical restructuring of the tax treatment in other cases when companies purchase or redeem their own shares, to bring them more directly into line with the apparent implications of the new Companies Bill - again with their consequential effects for other parts of the tax law (paragraphs 39 to 46).

Hitherto, except in certain very limited circumstances, limited companies in the United Kingdom have not been permitted to purchase their own shares. This position will be changed when the Companies (No.2) Bill currently before Parliament is enacted. The Government considers that the facility to purchase own shares would provide companies with valuable additional flexibility which might be used to contribute to the continuity and further development of companies, and to the deployment of corporate resources to the best effect. The Bill accordingly contains provisions enabling companies, if authorised by their articles, to purchase their own shares, and to issue redeemable shares, subject to safeguards for creditors and members.

The main conditions for redemption or purchase provided for in the Bill (on completion of its Committee Stage) are:

- (i) Subject to (v) below, shares may only be redeemed or purchased out of distributable profits (that is profits that are available for distribution within the meaning of Part III of the Companies Act 1980) or the proceeds of a fresh issue;
- (ii) Shares redeemed or purchased are to be treated as cancelled on redemption or purchase, and the amount of the company's issued share capital reduced by the nominal value of those shares. The amount of this reduction is to be transferred to a capital redemption reserve. Special provisions apply where shares are reduced or purchased out of capital (see (v) below).

(iii) Purchases of own shares must be authorised by the members. In the case of off-market purchases (that is shares purchased off a recognised stock exchange, or shares purchased on such a stock exchange but which are not listed or not subject to a "marketing arrangement" ^{" - which is "} (as defined in the Bill³), the Bill requires the purchase and the terms of the contract of purchase to be authorised by special resolution of the company. The Bill requires other purchases, that is market purchases, to be authorised by the company in general meeting. In this case, the authorisation may confer general authority, but it must specify the maximum number of shares to be purchased and the maximum and minimum prices which may be paid. The terms of any proposed contract pursuant to which a company may become entitled or obliged to purchase shares must be authorised by special resolution on a similar basis to authorisations of off-market purchases.

(iv) After a purchase of own shares, companies must make a return to the registrar stating the number and nominal value of shares of each class purchased, and the date of their transfer to the company. In the case of public companies, the return must also give the aggregate amount paid by the company, and the maximum and minimum prices paid in respect of shares of each class purchased.

v) Private companies, if authorised to do so by their articles may redeem or purchase their own shares out of capital, that is otherwise than out of distributable profits or the proceeds of a fresh issue. The amount of the payment out of capital which may be made is the amount of the cost of the redemption

or purchase less any distributable profits of the company or the proceeds of any fresh issues made for the purpose. Any payment out of capital must be approved by a special resolution of the company. Before any such resolution is passed, the directors must make a statutory declaration with regard to the payment out of capital, and the company's actual and prospective ability to pay its debts. The statutory declaration must be accompanied by an auditor's report. Provision is made for a proposed payment out of capital to be given publicity, and creditors may apply to the court for the resolution to be cancelled.