fact sheet

Share Buy-Backs

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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 25% net of the tax credit in income tax for the higher-rate taxpayer and 30.6% net of the tax credit for those who pay tax at the top rate for dividends of 37.5%.

So 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.

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. So, for the higher-rate taxpayer, there is a 25% tax charge on the increase, or a 37.5% tax charge for those paying tax at the highest rate.

However, if the employee-shareholder has owned the shares for at least 5 years, then any gain on the shares may qualify for capital gains tax treatment at 18% or 28% (depending upon income) or 10% if Entrepreneur’s Relief is available.

To obtain the capital gains treatment the company must be an unquoted trading company. A HM Revenue & Customs clearance procedure is available.

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 employment contract has ended 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 not 51% or more 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/) 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: please see the Everyman Legal fact sheet: ‘Treasury Shares’.

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.

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. This is the same as for a dividend and gives a tax credit of 1/9th the sum received.

What if the price cannot be met out of profits?

If the purchase price exceeds the available distributable reserves then an additional procedure to buy the shares back out of capital must be followed. This is only available to private companies not to public companies.

The procedures 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’
For further information, please refer to the following Everyman Fact Sheets:

‘Shareholders’ Agreements: Do I need One?’
‘Treasury Shares’

For anyone needing any corporate or technical legal support, there is no-one better to work with.

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