ESC 12 Purchase of Own Shares (PoS)

The Companies (Amendment) Ordinance 2006 allows companies to purchase their own shares. A purchase of own shares is a distribution according to the Taxes Ordinance 1997 (TO 1997). Section 49 of TO 1997 allows a tax credit for recipients of qualifying distributions, and taxes the total as income. A sale of shares other than to the company whose shares they are, is a capital transaction and does not suffer income tax except in particular cases (Individual Transferable Quota and Oil Rights).

The intention of this ESC is to allow the vendor in a purchase of own shares situation to be in a no worse position than a vendor to a 3rd party. Equally, the vendor should not be in a better position than a vendor to a 3rd party buyer.

The ESC will apply from 1 January 2007, the date that the Companies (Amendment) Ordinance 2006 came into force to allow a company to purchase its own shares.

In PoS transactions the tax office will treat the receipt as a capital repayment up to the amount of capital originally subscribed for the shares.

In certain circumstances where an unquoted private company purchases its own shares the Tax Office will treat the whole payment as a capital transaction (applying the ITQ and Ring Fence Trade legislation as appropriate first).

The circumstances are as follows:

- Where the redemption, repayment or purchase is made wholly or mainly for the purpose of benefiting a trade carried on by the company or by any of its 75 per cent. subsidiaries, and 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; and

- the conditions specified in this ESC, so far as applicable, are satisfied in relation to the owner of the shares

The conditions applying are:

- **trade benefit**

The company's sole or main purpose in making the payment is to benefit a trade carried on by it or by its 75% subsidiary.

If there is a disagreement between shareholders over the management of the company and this is having or is expected to have an adverse effect on the company's trade then this condition will be met if the effect is that the dissenting shareholder is removed entirely. Similarly an unwilling shareholder may wish to end his association with the company and the company wants to PoS rather than have them sold to someone who is not acceptable to the other shareholder. The purchase will normally be regarded as benefiting the company's trade. Examples of unwilling shareholders are:

- an outside shareholder who has provided equity finance and now wishes to withdraw the finance
- a controlling shareholder who is retiring as a director and wishes to make way for new management
- personal representative of a deceased shareholder where they wish to realize the value of the shares
- a legatee of a deceased shareholder where he does not wish to hold shares in the company

If the company is not buying all the shares owned by the vendor or the vendor is retaining some other connection, such as a directorship or consultant, it would be unlikely that the transaction could benefit the trade. However, there are exceptions where a company does not 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. It may be possible to show the main purpose is to benefit the trade. There is also no objection if, for sentimental reasons, the retiring director retains a small shareholding (5% or less) of the issued share capital.

- **residence**

the vendor must be resident for tax purposes as defined by S200-S201 TO 1997 (as amended)

- **period of ownership**

the shares must have been owned, either directly, through inheritance under a will or through a company reconstruction, for a minimum period of 5 years

- **substantial reduction in vendors interest in the company**

The percentage of share capital of the vendor (and his associates) immediately after the purchase must be less than three quarters of the percentage held immediately before it. Also, following the purchase the vendor (and his associates) must not be connected with company. For this purpose connection and control has the same meaning as S208-210 TO 1997, with the addition that he is also connected if he directly or indirectly possesses more than 50% of the loan capital and issued share capital of the company.

It sometimes happens that the company wants to buy out the shareholder completely but cannot afford to do so. In such a case the parties may agree that the PoS should go ahead but that the shareholder will lend part of the consideration back to the company immediately afterwards. There is no reason this should not happen. However, it is to be remembered that after the PoS the shareholder's interests in the company must not exceed 50%; where the shares have a high market value, the issued share capital being relatively small, it is possible that the loan may cause this rule to be breached. It is acceptable for the company to avoid this result by making a bonus issue before the PoS takes place thus increasing its issued share capital.

Example
Norman owns 5,000 out of the 10,000 issued £1 shares of a company.
It is agreed that the company will buy the shares for £75,000 which is their market value, and Norman will lend the company £25,000.

But this would mean Norman held loan capital of £25,000 out of the company's combined share and loan capital of £30,000 (5,000 remaining shares plus loan £25,000), so he would be connected with the company.

If, before the PoS, the company makes a bonus issue of 9 shares for each one held then Norman will hold 50,000 shares. He sells these for £75,000 and loans £25,000. Now the company's combined share and loan capital is £75,000 (50,000 shares and £25,000 loan). Norman's share is £25,000 which is less than 50% of the whole so he is not connected with the company.