Tax treatment of the sale and purchase of own company shares - revenue or capital transaction

Synopsis: General principles of the tax treatment of the purchase.

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Subject to the satisfaction of various conditions, a private company has the ability to buy back its own shares. In some cases, funding for this through appropriate life assurance is put in place. The main reasons for the buy back will be to ensure that the deceased shareholder or their family receive financial compensation and the company remains in the ownership of the continuing shareholders.

Depending on the circumstances, the buy-back transaction has either income tax or capital gains tax (CGT) implications.

Normally the payment of a sum of money from a company to a shareholder will be a distribution to the extent that it does not represent a repayment of capital - s1000 (1) B Corporation Tax Act 2010. This means that any excess over the subscription price will be treated as investment income of the shareholder.

The recipient will be liable to income tax on the amount received at the dividend rate(s) to the extent the distribution exceeds their dividend allowance (£5,000 in tax years 2016/17 and 2017/18 and reduced to £2,000 from the tax year 2018/19 to 2022/23, then £1000 for 2023/24 and £500 for 2024/25). Any amount taxable as income in the hands of the vendor is excluded from the CGT calculation (S37 TCGA1992).

Alternatively, subject to the rules, the transaction will be treated as giving rise to a chargeable disposal for CGT. Any gain arising, subject to reliefs and exemptions, could thus give rise to a CGT liability.

The CGT treatment will clearly be advantageous where business asset disposal relief (previously known as entrepreneurs' relief) is available or if the sale/purchase is made post-death (the shares having been re-valued at death). In other circumstances the distribution treatment of an "unauthorised" share purchase may result in a lower overall tax liability dependent on the income tax rate of the shareholder.

The distinction in treatment was at point in the case of *Moody-v-Tyler (Inspector of Taxes),* heard in March 2000, which concerned a company purchasing its own shares and whether payment should be treated as capital or as giving rise to a distribution: ss 1000(1)A and B. Corporation Tax Act 2010.

The taxpayer was a director of a family company until March 1989 when he resigned. He reached an agreement with the company, pursuant to which the company made a loan to him of £50,000. In May 1995, the company bought from him 2,747 shares out of his total shareholding for the sum of £50,000.

The £50,000 consideration was not passed to the taxpayer but used to discharge the loan by way of set off. The capital originally subscribed for the 2,747 shares was £2,747. The taxpayer received dividends of £4,150 from the company during 1995/96.

The inspector made an assessment to income tax under the provisions of Schedule F (dividends and other distributions) (now referred to as dividend income) in the sum of £63,216 for the year 1995/96.

The taxpayer appealed, contending that the payment made by the company in purchasing his 2,747 shares should be treated as capital and not as giving rise to a distribution under s1000(1)B CTA 2010 because the purchase had been made wholly or mainly for the purpose of benefiting the trade carried on by the company and hence s1000(1)A CTA 2010 applied.

Alternatively, he contended that if the payment made by the company was to be treated as giving rise to a distribution under s1000(1)B CTA 2010, it should be treated as having been made in the period during which the loan of £50,000 was spent by the taxpayer, namely April 1989 to May 1995.

Thirdly, he contended that it would be unfair to the taxpayer to treat the payment for the shares as giving rise to a distribution because neither his solicitor involved in the negotiations with the company nor the company's solicitor advised the taxpayer that such a payment would be treated in any way other than as capital.

The General Commissioners upheld the assessment and found as a fact that under s1002(1) CTA 2010 there had been a distribution by the company and when that was grossed up at the prevailing rate of advance corporation tax the income was £59,066; further, that when that was added to the other income received by the taxpayer from the company the correct assessable figure was £63,216.

The taxpayer appealed.

The Court decided that the Commissioners’ decision was based on facts and there was no basis on which the Court could interfere with their decision. Accordingly, the taxpayer's appeal was dismissed.

In the case in question, the HMRC found that there was no evidence that the purchase was for the purpose of benefiting a trade carried on by the company. Based on the facts, the most obvious conclusion was that the purpose of the payment made by the company was to write off the former director's debts. It is therefore difficult to see a fault in the Commissioners’ assessment of the facts.

In this case, the only real issue before the Court on the substance of the matter dealt with by the Commissioners was whether or not the payment was to be treated as a distribution or fell within one of the exceptions; namely, a payment made wholly or mainly for the purposes of benefiting the trade carried on by the company in which case the transaction would be a capital transaction with any gain being subject to capital gains tax.

That was a pure question of fact. The Court could find no error of law in respect of that finding or any other finding in the decision.

If advance funding for the purchase by a company of its own shares is to be put in place (through life assurance), one of the main reasons (if not the main reason) for adopting the corporate route is that the cost, i.e. the premiums, would be met out of after corporation tax income as opposed to after income tax (and possibly national insurance (NIC)) income.

In making the corporate choice, however, it is essential that both the adviser and the client are aware that company law conditions need to be satisfied before a purchase can be made and tax clearances secured if an income tax charge is to be avoided.

The key tax condition to satisfy is the "benefit of the trade" condition. The case referred to above serves as a reminder of the cost of not satisfying this test.

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