

PURCHASE OF OWN SHARES FROM TRUSTEE SHAREHOLDERS

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The various and complex issues arising from a company's purchase of its own shares have attracted recent learned comment (see, e.g., Tiley 1992 BTR 21 where a comparison between the relevant UK and US provisions is made). Quite apart from the questions which affect all such transactions, trustees selling shares in a company to the company itself must take into account additional considerations which apply to such sales by trustee shareholders only. The purpose of this article is to highlight those issues of particular interest to trustees and alert the unwary to some of the pitfalls.

The Company Law Background

A company may purchase any of its own shares, including redeemable shares, provided it has the necessary authority in the articles (CA 1985 s.162(1)). Authorisation is given in Table A, article 35. Shares can only be purchased if they are fully paid (s.162(2) applying s.159(3)).

After a company has purchased its own shares, it must cancel them (s.162(2), applying s.160(4)). The cancellation of the shares purchased necessarily means that the share capital is diminished to that extent. The reduction must be compensated for either by new contributed capital from a new issue of shares, issued specifically for that purpose, *or* by transferring distributable profits from the profit and loss account to a capital redemption reserve (s.160(1) applied by ss.160(2), 170(1),(2)).

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If the purchase price of the shares exceeds the nominal value, the excess is treated as a redemption premium on the redemption of a company's own shares. For a public company, the excess must be paid out of distributable profits unless the "premium" represents a repayment of share capital on the basis that it was a share premium contributed when the shares were issued, in which case it can be deducted from the share premium account, assuming that the account has not been used for other purposes (s.162(2) applying s.160(1)(b), (2)).

If the articles so permit (authorisation is given in Table A, article 35), the purchasing company may write down its share capital account after the purchase of its own shares to the extent that the purchase price is not covered by the proceeds from a new share issue or distributable profits (s.171(1)). The amount written off is a "payment out of capital".

A private company *only* may choose to pay for its own shares otherwise than from the proceeds of a fresh issue of shares or distributable profits by making a "payment out of capital". In this case the redemption premium may have to be written off any available capital account or the revaluation reserve (s.171(5)).

Different procedures and requirements for authorisation apply to a purchase of own shares, depending on whether the purchase is off market or on market (ss.164(1), 166). In either case there are requirements as to disclosure and publicity (ss.169, 164(6)).

Trust Income or Capital?

The shares held by the trustees of any trust will constitute part of the trust capital of that trust before the purchase (we ignore the rare cases where the trustees are dealing in shares). What of the proceeds of sale? The question is of crucial importance and merits close study.

Commonsense dictates that where shares are held as a capital asset, their proceeds of sale ought also to constitute trust capital. It is settled that a company may capitalise its profits by applying them in paying up new shares to be issued to shareholders and that in such a case the new shares rank as capital (*Bouche v Sproule* (1887) 12 AC 385). This remains the case whether the capitalisation is effected by issuing bonus shares (e.g., *Re Speir* [1924] 1 Ch 359), debentures (*CIR v Fisher's Executors* [1926] AC 395; *Commissioner of Income Tax, Bengal v Mercantile Bank of India Ltd* [1936] AC 478) or redeemable loan stock (*Re Outen's WT* [1963] Ch 291). Why should the sale of share capital even to the company itself be anything other than a capital transaction?

To confirm what commonsense suggests it is necessary first to dispose of a possible contrary argument based on *Hill v Permanent Trustee of New South Wales* [1930] AC 720. This is a case which has attracted increasing attention in the

context of s.213 demergers (see, e.g., McCall: "Demergers and Trusts" 1 PTPR 3 (1991/92) 199).

In *Hill*, a company sold off the whole of its assets and ceased to carry on business. The company declared and paid a dividend, stating that it was paid out of the proceeds of sale of the assets. The Privy Council held that the dividend was an income payment which, in the case of trustee shareholders, fell to be paid to the income beneficiary rather than belonging to trust capital.

Lord Russell observed at page 731:

"A limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorised reduction of capital. Any other payments made by it by means of which it parts with moneys to its shareholders must and can only be made by way of dividing profits...moneys so paid to a shareholder will (if he be a trustee) prima facie belong to the person beneficially entitled to the income of the trust estate."

The proposition set out by Lord Russell that a payment by a company to shareholders which is not in respect of a reduction of share capital or an addition to shareholders' capital investment is income is well established (see *In re Duff's Settlement*, *National Provincial Bank Ltd v Gregson and Others* [1951] Ch 923 (CA); *Rae v Lazard Investment Co Ltd* [1963] 1 WLR 555 (HL) per Lord Reid at 565).

Furthermore, the character as a matter of company law of any given distribution, ascertained by reference to the legal mechanism employed in the distribution, determines its character in the hands of the recipient. (See *In re Duff's Settlement* above at 929 per Jenkins LJ and *Rae v Lazard Investment Co Ltd* above at 567 per Lord Reid).

As Lord Reid declared in *Rae v Lazard Investment Co Ltd* at 567:

"In deciding whether a shareholder receives a distribution as capital or income, [English] law goes by the form in which the distribution is made rather than by the substance of the transaction. Capital in the hands of the company becomes income in the hands of the shareholders if distributed as a dividend, while accumulated income in the hands of the company becomes capital in the hands of the shareholders if distributed in a liquidation."

We have already seen that a purchase of own shares requires a reduction in the share capital account of the purchasing company with a compensating payment into a capital redemption reserve, which comes from distributable profits (assuming there is no new share issue).

It might be argued that, since the undistributable reserves of the purchasing company remain unchanged after the transaction is effected, with the ultimate movement occurring in the distributable profits, *Hill* applies to categorise the purchase as an income distribution. This, if correct, would be the case whether the purchase of own shares was governed by ICTA 1988 s.219 or not. Any such argument would be wrong on principle and on authority.

The purchase of own shares necessarily involves a reduction in share capital and so satisfies the test in *Hill* itself that such a transaction is properly viewed as giving rise to trust capital in the hands of trustee shareholders. The fact that the undistributable reserves remain constant is, quite simply, irrelevant. On the other hand it is significant that the corpus of the asset (shares in the company) held by the trustees after the purchase of shares is clearly diminished, which strongly implies a capital transaction: *Rae v Lazard Investment Co Ltd* above at 568; *Courtaulds Investments Ltd v Fleming* (1969) 46 TC 111 at 124, 125.

In *In re Duff's Settlement* above, settlement trustees held shares in a company which periodically allotted shares at a premium under CA 1948 s.56. The premiums were transferred to a share premium account. The company passed a resolution, with Court sanction, to pay a sum in respect of each fully paid share. The sum was duly paid to the trustee shareholders out of the share premium account.

The court held that the sum was capital on the basis that the share premium account was not part of the distributable reserves of the company and was outside the *Hill* principle. Furthermore, a distribution of a share premium account was an effective reduction of share capital because it paid off paid up share capital. This notionally paid up share capital was to be treated as paid up on the shares participating in the distribution which were treated as if the nominal amounts and amounts paid up on them included attributed proportions of the share premium account. Section 56 treated the company as having paid off the sum distributed on the issued shares by way of reduction in capital. Each share held by the shareholders was treated as a fully paid up share valued by a return of capital to the extent of the sum distributed. The sum distributed left the company as paid up capital returned to members and accordingly trustee shareholders were treated as receiving as trust capital share capital returned by the company.

If, applying *Duff*, a notional reduction of capital is a capital transaction, an actual reduction of share capital must even more clearly be so treated.

The Tax Treatment

The general rule is that the proceeds of sale of a purchase of own shares constitute, at least in part, a distribution for tax purposes, taxable under Schedule F. The general rule applies unless the purchase price is less than the originally subscribed capital or the purchase is within the terms of the regime established by ICTA 1988 ss.219-229, in which case the transaction is subjected entirely to capital gains tax treatment.

Section 219 will apply capital gains treatment to the purchase if the various conditions in ICTA 1988 ss.219-223 are satisfied.

When the s.219 conditions are not satisfied, the part of the purchase monies which exceeds (broadly) the originally subscribed capital, inclusive of any premium, will be an income distribution taxable under Schedule F; ICTA 1988 s.209(2)(b). The purchasing company will be liable for ACT on the distribution element. In the hands of the vendor, the amount taxed as income does not attract CGT, because of TCGA 1992 s.37, unless the vendor is a company. In that circumstance the Revenue argue that despite ICTA 1988 s.208 a chargeable gain can arise if the vendor is a company. This controversial conclusion is outside the scope of the present article; see SP4/89.

Trustees pay only the basic rate of income tax on that part of the purchase money categorised as a Schedule F distribution and that liability will be discharged by the ACT credit attaching to the deemed distribution in the hands of the trustees; ICTA 1988 s.231(3). In other words, assuming the company can utilise the ACT against its liability to mainstream corporation tax, the transaction can be effected at a nil tax cost to both the trustees and the purchasing company. We will call this "the optimum case".

This analysis of the optimum case makes the following assumptions:

1. The tax charge falls on the *trustees*, not the settlor or any income beneficiaries at their marginal rates.
2. In the case of discretionary trusts the purchase monies do not fall foul of the terms of ICTA 1988 s.686.

These assumptions are further considered below.

An additional advantage of income tax treatment is that it can create a loss for CGT purposes, provided again that the above assumptions hold good.

The analysis is as follows:

1. The purchase of shares by the company constitutes a CGT disposal by the trustees, even though part of the disposal proceeds are taxed as income.
2. That part of the purchase money categorised as a Schedule F distribution is excluded from the CGT computation (TCGA 1992 s.37(1)).
3. The consideration for the disposal of the shares must accordingly be taken as that part of the purchase price not categorised as a distribution, i.e., the original subscription monies. It follows that a capital loss is capable of arising on the purchase of own shares being effected:

For example:

Trustees own 100 shares in X Ltd - the original subscription price at par was £1,000.

The Trustees have a base cost of £10,000 (on, say, March 1982 rebasing or on acquisition of the shares from another party), ignoring indexation.

X Ltd buys the shares back for £11,000 in circumstances to which ICTA 1988 s.219 does not apply.

The Trustees receive a distribution of £10,000 plus an ACT credit of £3,333² (which shelters the Basic Rate Tax liability of the trustees in respect of the distribution).

The Trustees make a capital loss of £9,000 (£10,000 less £1,000). To that can be added any indexation allowance based on the original base cost of £10,000.

An important qualification on this analysis is that it assumes TCGA 1992 s.17 does not apply to the transaction. Assuming full value is paid for the shares, s.17 is unlikely to have any practical significance. Another important consideration is whether, if the vendor trustees are connected with the purchasing company, the use of any resultant loss is restricted by TCGA 1992 s.18. The Revenue view is understood to be that there is no such restriction because the company makes no acquisition. As a result the company cannot itself claim any allowable loss when the shares are cancelled. As to whether this view is correct the writers hold divergent views!

² Using pre-Budget rates.

Application of Specific Rules to Trustees

Let us assume Schedule F treatment for the purchase of own shares from trustee shareholders. The tax treatment of the purchase monies in the hands of trustee shareholders depends crucially on the income-capital distinction in trust law discussed above, together with the scope of various anti-avoidance provisions in ICTA 1988 applying to settlements. We consider the three main types of settlement in turn:

- (1) *Settlements where settlor (and spouse) are not excluded from benefit:*

The optimum case depends on the purchase monies being established as trust capital. It further depends on certain anti-avoidance provisions not applying to the transaction.

Even though the purchase monies are trust capital the settlor will nevertheless be liable to tax at his marginal rate on the distribution element of the purchase monies.

Consider a situation where the purchase of own shares is established as a capital transaction for trust purposes but is subjected to Schedule F distribution treatment, as in the optimum case. This deemed income is subjected to Part XV treatment. "Income arising under a settlement" is defined in ICTA 1988 s.681 for the purposes of Chapter III of Part XV of the Act (which includes ss.673, 674 and 674A) as "any income chargeable to income tax by deduction or otherwise". The definition in the writers' view encompasses "deemed" income categorised as a Schedule F distribution as well as monies constituting trust income at general law. While the settlor would normally have a statutory right to recover the tax from the trustees, the effect of Part XV will have been to increase the rate of tax to the settlor's marginal rate.

There is a further consideration which must be addressed if the settlor is taxed on the deemed income under the Part XV provisions. In the optimum case, the trustees are not subjected to capital gains tax treatment on that part of the purchase money categorised as income. TCGA 1992 s.37(1) excludes income receipts from a CGT computation when those receipts have been charged to income tax *in the hands of the person making the disposal*, in this case the trustees. Where a settlor is caught by the Part XV settlement provisions, this exclusion from a capital gains tax computation appears not to apply. The recipients of the purchase money, i.e., the trustees, will *not* be subject to income tax at all. It follows that there is at least a technical CGT liability on the trustees in respect of the *whole* purchase money. The settlor is taxed on the part of the purchase

money categorised as a distribution attributed to him under the Part XV provisions. This gives rise, theoretically at least, to a double charge to tax on the part of the purchase money categorised as a distribution; one in respect of CGT in the hands of the trustees and another to income tax in the hands of the settlor.

(2) *Settlement where the settlor has not retained an interest*

(a) Settlement where a beneficiary has an interest in possession.

Since the purchase monies are trust capital they do not belong to the income beneficiary. The categorisation of part of the purchase monies as a Schedule F distribution is, in the absence of an equivalent to ICTA 1988 Part XV for income beneficiaries, irrelevant and will normally have no tax consequences for them.

(b) Discretionary Trusts.

ICTA 1988, s.686 (additional rate tax) applies to "income which is to be accumulated or which is payable at the discretion of the trustees or any other person (whether or not the trustees have power to accumulate it)".

The terms of s.686 are not restricted to trust income of accumulation and discretionary trusts, or to income encompassed by s.31 of the Trustee Act 1925 (power to apply income for the benefit of an infant and accumulate the remainder). Is there any reason why s.686 cannot encompass deemed income also?

Even if the purchase monies categorised as a Schedule F distribution cannot constitute "income" which is to be accumulated for s.686 purposes, could they constitute "income payable at the discretion of the trustees"? The short answer, in the writers' view, is "no".

This does not emerge unambiguously from the words of s.686, but it is considered that the terminology of s.686(2)(a) in particular indicated that the draftsman is concerned with income as a matter of trust law, rather than income as a matter of tax law. Trust capital which for income tax purposes is to be treated as income is not "income which is to be accumulated". Nor is it aptly described as "income which is payable at the discretion of the trustees". The Inland Revenue are understood to accept this interpretation, though for complete safety an interest in possession could be appointed or discretions over "income" removed before a purchase of own shares took place.

ICTA 1988 sections 739, 740

Similar issues arise in respect of ICTA 1988 ss.739, 740. Section 739(2) applies where there has been a transfer of assets and charges to tax the transferor, who or whose spouse, has power to enjoy income which in consequence of the transfer becomes the income of a non-UK resident or domiciled person. Section 740 taxes persons other than the transferor to the extent that such persons receive a benefit not otherwise chargeable to income tax. A settlement of shares of a UK company in an offshore trust will, for example, constitute a transfer of assets caught by both s.739 and s.740. If that company purchases shares in itself held by the trustees, does that part of the purchase money categorised as a Schedule F distribution constitute "income" for s.739 and s.740 purposes?

"Income" is not defined in respect of either s.739 or s.740. It is tempting to follow Viscount Dilhorne in *Lord Chetwode v IRC* [1977] STC 64 at page 71, where he observed that in respect of s.739 (then ICTA 1970 s.412) "income is an ordinary word in the English Language and, unless the context otherwise requires, it should be given its ordinary natural meaning in a statute". Arguably the "natural" meaning of income in the context of trustee shareholders selling shares in a company to the company itself excludes receipts which constitute trust capital. Such receipts are only deemed to be income for the purpose of bringing them within the definition of "distribution" for s.209 purposes. It is not, however, thought that this optimistic interpretation can prevail. As Lord Wilberforce observed, "income" in s.739 means income within the UK tax code, and there can be no doubt a distribution is such income (ICTA 1988 s.20). As a result "income" for the purposes of ss.739 and 740 must be regarded as including the distribution element of any price paid on the purchase by a company of its own shares.

ICTA 1988 section 776

Is there any exposure under s.776 to trustees involved in a purchase of own shares where the shares represent property deriving their value from land? Section 776

requires a "gain of a capital nature" to be made for that provision to apply. That term must be construed in the light of the definition of "capital amount" defined in s.777(13) as "any amount in money or money's worth which...does not fall to be included in any computation of income". Is this term sufficiently wide to apply s.776 to all or part of the purchase monies if the other provisions of s.776 are satisfied?

Section 776 clearly cannot apply to that part of the purchase price categorised as a Schedule F distribution. This sum is clearly subjected to income tax treatment. Or is it? The optimum case involves a complete sheltering of income tax liability by the use of the ACT credit. Is the sum in question properly said to be "included" in an income tax computation? The correct answer must be "yes". The Basic Rate Tax liability has simply been discharged by the ACT credit.

What of that part of the proceeds of sale of the shares which is not treated as income? Can this give rise to an income tax liability under s.776? Yes, if the actual base cost (as opposed to any deemed CGT base cost) is less than the subscription price. Otherwise, no, because s.776 applies to gains and not to losses and if the actual base cost exceeds the part of the repurchase price taxed as capital, the transaction will inevitably give rise to a capital loss.