Think Ahead ACCA

Technical factsheet:

Company purchase of own shares

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1. INTRODUCTION

Private companies often decide to purchase their own shares from shareholders. A common situation is when an existing shareholder wants to sell some or all of his/her shares and the other shareholders are unwilling or unable to purchase them. This factsheet also provides an overview of a reduction of capital which involves no payments being made by the company to shareholders.

The legal, tax, accounting, reporting and general business planning issues need to be carefully considered. Ethical matters will also need to be considered by both accountants working in the business and external advisers if the accountant is advising both the company buying the shares and the shareholder selling the shares.

2. LEGAL ASPECTS

Companies Act 2006 sections 641 to 653 deal with reduction of share capital and Part 18 sections 658 to 737 deal with the purchase by a company of its own shares. A summary of these sections can be found in Appendix 1.

The following legal requirements apply, if permitted by the articles of the company:

- A private company may redeem or purchase its shares out of capital by passing an ordinary resolution together with a statement by each of the directors that the company is solvent, supported by an auditors' report as to the reasonableness of such a statement. See Appendix 3 for an example of an ordinary resolution.
- A private company may reduce its capital by issuing a solvency statement and passing an ordinary resolution. This procedure does not require a report by the auditors.
- Public companies continue to require court approval for capital reduction.

A private company is able to provide financial assistance for the purchase of its own shares, or shares of its private holding company, provided that it does not result in an unlawful reduction of capital.

However, Companies Act 2006 prohibits a public company from giving financial assistance directly or indirectly for the purpose of the acquisition of its shares or those of its holding company, or for the purpose of reducing or discharging any liabilities incurred in the acquisition of such shares (CA2006 s678 and s679).

Treasury shares

Statutory instrument 2013 number 999 (SI 2013/999) simplified the rules for share buy backs and allows all companies limited by shares to hold their own shares in treasury. Companies Act 2006 sections 724 to 732.

In respect of the authorising of share buy backs the following is available:

1. Allow off-market share buy backs to be authorised by ordinary resolution (special resolution was required before 30 April 2013). An off-market share buy back is one where the purchase of a company's own shares does not take place on a recognised investment exchange.
2. Allow for the prior approval of multiple off-market share buy backs, for the purposes of an employee share scheme, to be authorised by a single ordinary resolution. The resolution will specify the conditions under which the shares may be bought back and will give the maximum number of shares that can be bought back, the price range and the time of expiry of the authorisation, that cannot exceed five years.

In respect of the financing of share buy backs the following amendments have been introduced:

1. Allow private limited companies to pay for their own shares by instalments where the share buy back is in connection with an employee share scheme. (Previously under Companies Act 2006 section 691, when a company purchased its own shares it had to make full payment on the date it bought back those shares.)
2. Allow private limited companies to buy back shares in connection with an employee share scheme to finance the purchase out of capital using a simplified procedure. This simplified procedure consists of the directors signing a solvency statement and

the shareholders passing a special resolution. (Previously when shares were bought back out of capital, the directors needed to produce a solvency statement which the auditors reported on, shareholders passed a special resolution, a public notice of proposed payment was issued and the directors' statement and auditor's report was made available for inspection.)

3. Allow private limited companies to buy back shares using 'small' amounts of cash if authorised to do so by its articles and without having to identify the cash as from distributable reserves. Small in this respect is the lower of £15,000 and the cash equivalent of 5% of its share capital in each financial year. Section 692 of the Companies Act 2006 allows a private company to purchase a limited amount of its own shares without using the other three sources of finance allowed by the Companies Act 2006 (these being distributable profits, proceeds of a fresh issue of shares and capital [for private companies]).

In respect of a company being able to hold its own shares as treasury shares, the following has been introduced:

Allow all companies limited by shares to hold their shares as treasury shares. Section 724 was amended as previously only public companies with listed shares were able to hold their own shares as treasury shares. The shares allowed to be held in treasury are those acquired out of distributable profits or, for private companies, with small amounts of cash (as explained above).

3. TAXATION

The shareholder selling the shares will be taxed on the sale of his/her shares to the company either based on the 'distribution treatment' or 'capital treatment'. Distribution treatment is broadly the same as a dividend and subject to income tax, whereas under the capital treatment the disposal is subject to capital gains tax.

HMRC has issued guidance on the targeted anti-avoidance rule (TAAR) in Company Taxation Manual 36300: bit.ly/ctm-36300.

The purpose of this TAAR is to prevent individuals converting what would otherwise be a dividend into a capital payment, and so reducing their overall tax liability. This applies to distributions in a winding-up made on or after 6 April 2016, regardless of when the winding-up commenced.

A distribution in a winding up made to an individual on or after 6 April 2016 will be treated as if it were an income distribution where all of the following conditions are met:

Condition A: The individual receiving the distribution had at least a 5% interest in the company immediately before the winding up.

Condition B: The company was a close company at any point in the two years ending with the start of the winding up.

Condition C: The individual receiving the distribution continues to carry on, or be involved with, the same trade or a trade similar to that of the wound-up company at any time within two years from the date of the distribution.

Condition D: It is reasonable to assume that the main purpose, or one of the main purposes, of the winding up is the avoidance or reduction of a charge to income tax.

Where certain conditions exist, CTA 2010 s1033 provides that the distribution treatment does not apply to a payment made by an unquoted company on redeeming or purchasing its own shares. The effect is that the vendor is treated as receiving a capital receipt. However, if the vendor is a share dealer, the receipt will be trading income.

CTA 2010 s1033 provides that the purchase consideration is exempt from distribution treatment under CTA 2010 s1000 if either:

- the purchase is made wholly or mainly for the purpose of benefiting a trade, and certain other conditions are met (CTA 2010 s1033(2)(a)) or
- the purchase is made to enable the vendor to pay inheritance tax (specific exemption in CTA 2010 s1033(3)).

Where the conditions in CTA 2010 s1033 are satisfied capital treatment is automatic. It cannot be ‘disclaimed’. Nevertheless the vendor may be able to break one of the conditions to secure distribution treatment if this is beneficial.

HMRC will give clearance for capital treatment only if the purchase consideration is to be fully paid immediately on completion and paid in money. This means that payment by instalments is not possible. HMRC has indicated that is it possible to make a contract under which successive tranches of shares are to be purchased on specified dates.

Under CTA 2010 s1044, a company proposing to make such a payment may ask HMRC to confirm either that CTA 2010 s1033 will apply, or that it will not apply. Further guidance on this clearance procedure can be found in SP2/82, the link for which can be found below. SP2/82 also gives guidance on the ‘trade benefit’ test referred to above. (SP2/82 has been reproduced in Appendix 5.)

If a company makes a purchase of own shares that it believes falls within CTA 2010 s1033, it must make a return of the transaction to the Inspector (CTA 2010 s1046).
The return must:

1. be made within 60 days of the payment
2. give particulars of the payment
3. explain why the company believes that CTA 2010 s1033 applies to the payment so as to exempt it from treatment as a distribution (see Statement of Practice SP2/82 (link below and Appendix 5)).

The company must make such a return even if the board has confirmed that CTA 2010 s1033 will apply to the payment.

If the company has agreed to pay the legal costs relating to a purchase of own shares, such costs are generally disallowable in computing the company’s trading income. This is on the grounds that they are:

1. capital expenditure in respect of the company’s share capital, or
2. within ICTA88 s74(1)(f).

The expenditure is also likely to fail the wholly and exclusively test under ICTA88 s74(1)(a). Company Taxation Manual CTM17320 contains information on the relevant law references concerning relief for costs of distributions and demergers; this can be found at http://www.hmrc.gov.uk/manuals/ctmanual/CTM17320.htm

HMRC has produced the following document, which has useful taxation information relating to company purchase of own shares:

Statement of Practice SP2/82 is reproduced in Appendix 5 and can also be found at https://www.gov.uk/government/publications/statement-of-practice-2-1982.

It is for the company and vendor shareholder to agree a price for the shares. However, the directors have obligations to creditors and the shareholders. The following tax implications may arise if the company purchases its own shares for a value other than market value:

Purchase consideration exceeds market value

1. If HMRC can show that the purchase is not 'a bargain made at arm's length', then it may seek to apply TCGA 1992, s17, which provides for market value to be substituted for the actual consideration. HMRC explains what it considers is 'a bargain made at arm's length' in *Capital Gains Manual CG14542*, which can be found at http://www.hmrc.gov.uk/manuals/cgmanual/CG14542.htm.
2. HMRC may argue that the excess of the consideration over market value is a distribution under ICTA 1988, s209(4).
3. HMRC may argue that the excess could fall within the definition of remuneration due to the wide scope of ICTA 1988, s19.

Purchase consideration less than market value

1. HMRC may argue that TCGA 1992, s17 should be applied (as explained above). This may result in a chargeable gain greater than the vendor expected. The excess is a gift to the company, although hold-over relief under TCGA 1992, s165 is not available.
2. The gift will be a transfer of value for inheritance tax purposes, which will not be a potentially exempt transfer because it is a transfer to a company.
3. Business property relief may be available on the transfer of shares, although this would not apply if death occurred within seven years as the shares are cancelled on

acquisition by the company and therefore cannot remain within the estate of the recipient.

4. A transfer at undervalue followed by some remaining connection with the company may result in the 'reservation of benefit' provisions being relevant and the estate on subsequent death could be treated as including the gifted element.

4. ACCOUNTING

CA 2006 s686 allows only redeemable shares to be redeemed if they are fully paid. Similarly, s 691 allows only a limited company to purchase its own shares if they are fully paid, unless purchasing the shares in relation to an employees' share scheme.

Treasury shares

Companies Act 2006 sections 724 to 732 deals with treasury shares. The Companies (Acquisition of Own Shares) (Treasury Shares) Regulations 2003 (SI 2003 No. 116) amended the Companies Act 1985 so that in certain circumstances qualifying shares may be held 'in treasury' for future sale by the company.
Statutory Instrument 2013 No. 999 made further amendments with effect from 30 April 2013 in relation to treasury shares. From that date private companies were able to hold treasury shares.

Capital redemption reserve

Where shares are redeemed or purchased wholly out of profits available for distribution, a sum equal to the amount by which the company's share capital is diminished on cancellation of the shares (the nominal value of the shares) should be transferred to the capital redemption reserve (CRR). (CA 2006 s733)

Where the redemption or purchase is financed wholly or partly by a new issue of shares, the transfer to the CRR is reduced by the proceeds of the new issue. In the case of a private company, the transfer to the CRR should be further reduced to the extent that the company can make a permissible capital payment.

If treasury shares are cancelled in accordance with CA 2006 section 729(4), the amount by which a company's share capital is diminished must be transferred to the CRR. (CA 2006 s733(4)

The capital redemption reserve may only be used subsequently to make a bonus issue of shares, although the provisions of the Companies Act relating to the reduction of a company's share capital apply as if the CRR were part of its paid-up share capital.

Appendix 3 examples 1, 2 and 3 demonstrate the accounting treatment.

Share premium account
Where the shares to be redeemed or purchased were issued at a premium and a fresh issue of shares is made for the purposes of the redemption or purchase, any premium payable on redemption or purchase may be charged against the share premium account.

The premium so charged cannot exceed the lower of:

a. the premium received on the issue of the shares now being redeemed or purchased
b. the current balance of the share premium account, including any premium on the new share issue
c. the proceeds of the fresh issue.

Therefore, where there is no fresh issue of shares, no amount may be charged to the share premium.

Appendix 3 example 5 demonstrates the accounting treatment.

Permissible capital payments (only applicable to private companies)
The permissible capital payment (PCP) is the amount by which the purchase or redemption cost exceeds the amount of distributable profits plus the proceeds of any new share issue.

If the PCP is less than the nominal value of the shares redeemed or purchased, the difference is transferred to capital redemption reserve (CA2006 s 734(2)). This means that a private company should use its available profits and any share proceeds before making a payment out of capital.

If the PCP is more than the nominal value of the shares redeemed or purchased, the excess may be used to reduce any of the following:

a. capital redemption reserve
b. share premium account
c. revaluation reserve
d. fully paid share capital (CA2006 s 734(3)).

Appendix 3 examples 4, 6 and 7 demonstrate the accounting treatment.

The following procedures must be followed before a payment out of capital can be lawfully made:

1. The payment must be approved by a special resolution (CA 2006 s716(1).
2. The directors must make a statement (CA 2006 s714(1-3).
3. A report by the company's auditors must be annexed to the directors' statement (CA 2006 s714(6).
4. Within a week of the date of the special resolution, a notice of the proposed capital payment, giving the information specified in CA 2006 s719, must be published in the Gazette.
5. Within a week of the date of the special resolution, a notice of the proposed capital payment, giving the information specified in CA 2006 s719, must be published in a national newspaper or given by written notice to each creditor.

The directors' S714 statement is explained in greater detail:

Under CA2006 s714(1-3), the directors are required to issue a statement that must specify the amount of the permissible capital payment for the shares in question and that, in their opinion as regards its initial situation following the date on which the payment out of capital is proposed, there will be no grounds on which the company could then be found unable to pay its debts, and for the following year the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due).

In forming their opinion, the directors must take into account all of the company’s liabilities (including any contingent or prospective liabilities).
The directors’ statement must be in the prescribed form and must have annexed to it a report by the auditor stating that they have enquired into the company’s state of affairs, that the permissible capital payment for the shares in question has been properly determined and that they are not aware of anything to indicate that the opinion expressed by the directors as to the ability of the company to pay its debts and continue as a going concern is unreasonable.

Reduction of capital (by special resolution and solvency statement): available to private companies

This reduction generally applies:

- where the company wishes to reduce the liability on any of its shares in respect of share capital not paid up
- where the company is over-capitalised
- where the company has suffered a loss of capital (ie cancelling share capital which is unrepresented by available assets).

Appendix 3 example 8 demonstrates the accounting treatment.

CA 2006 s641 and statutory instrument, ‘The Companies (Reduction of Share Capital) Order 2008’ (SI 2008/1915), sets out the means by which a company can reduce its share capital. This procedure also applies to a reduction in those reserves that have similar characteristics to share capital (ie the share premium account and the capital redemption reserve), although it does not apply to any merger reserves. For private companies, court approval and an auditors’ report are not required.

CA 2006 s641(2) states that this method of capital reduction cannot be used if, after the reduction, there would no longer be any member of the company holding shares other than redeemable shares or if the articles do not permit it.

This procedure is that directors make a solvency statement confirming that each director:

1. has formed the opinion, as regards the company's situation at the date of the statement, that there is no ground on which the company could then be found to be unable to pay (or otherwise discharge) its debts; and
2. has also formed the opinion
   a. if it is intended to commence the winding up of the company within 12 months of that date, that the company will be able to pay (or otherwise discharge) its debts in full within 12 months of the commencement of the winding up; or
   b. in any other case, that the company will be able to pay (or otherwise discharge) its debts as they fall due during the year immediately following that date.

The statement must:

a. be in writing
b. indicate that it is a solvency statement for the purposes of CA2006 s642
c. state the date on which it is made
d. name each of the directors of the company
e. be signed by each of the directors.

The shareholders must pass a special resolution reducing the share capital no later than 15 days after the directors have made the solvency statement.

No later than 15 days after the shareholders have passed the special resolution, the company must file with the Registrar of Companies:

1. the solvency statement
2. the special resolution
3. a statement of capital setting out the details of the share capital as reduced
4. a statement by the directors confirming that the solvency statement was made not more than 15 days before the date on which the special resolution was passed and that it was provided to members in accordance with the requirements of the act.

The resolution takes effect on registration by the registrar. Creditors have no right to object to a reduction of capital supported by a solvency statement. Statutory Instrument 2008/1915 states that a credit to reserves arising from a reduction or cancellation of capital supported by a solvency statement is a realised profit.

Examples of the accounting treatment are in Appendix 3.

5. IMPACT DISTRIBUTABLE PROFITS HAVE ON PURCHASE OF OWN SHARES

Section 692 of the Companies Act 2006 says that unless purchasing its own shares out of capital or paying fairly small amounts of money for the shares, then a limited company may only purchase its own shares out of:

1. distributable profits of the company or
2. the proceeds of a fresh issue of shares made for the purpose of financing the purchase.

Section 711 of the Companies Act 2006 defines 'available profits' as follows:

1. For the purposes of this chapter the available profits of the company, in relation to the redemption or purchase of any shares, are the profits of the company that are available for distribution (within the meaning of Part 23).
2. But the question of whether a company has any profits so available, and the amount of any such profits, shall be determined in accordance with section 712 instead of in accordance with sections 836 to 842 in that part.

Section 712: Determination of available profits

The available profits of the company are determined as follows:

1. First, determine the profits of the company by reference to the following items as stated in the relevant accounts:
    a. profits, losses, assets and liabilities
    b. provisions of the following kinds:
        i. where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under section 396
        ii. where the relevant accounts are IAS accounts, provisions of any kind

c. share capital and reserves (including undistributable reserves).

2. Second, reduce the amount so determined by the amount of:

   a. any distribution lawfully made by the company, and

   b. any other relevant payment lawfully made by the company out of distributable profits,

   after the date of the relevant accounts and before the end of the relevant period.

3. For this purpose, ‘other relevant payment lawfully made’ includes:

   a. financial assistance lawfully given out of distributable profits in accordance with Chapter 2

   b. payments lawfully made out of distributable profits in respect of the purchase by the company of any shares in the company, and

   c. payments of any description specified in section 705 (payments other than purchase price to be made out of distributable profits) lawfully made by the company.

4. The resulting figure is the amount of available profits.

5. For the purposes of this section ‘the relevant accounts’ are any accounts that:

   a. are prepared as at a date within the relevant period, and

   b. are such as to enable a reasonable judgment to be made as to the amounts of the items mentioned in subsection (2).

6. In this section ‘the relevant period’ means the period of three months ending with the date on which [the solvency statement is made in accordance with section 720A or] the directors' statement is made in accordance with section 714.

Effect of FRS 102 on distributable reserves

Investment properties are normally revalued each year, with revaluation gains being credited to profit and loss for the year. However, these amounts are not available for distribution until the property is sold.

Revaluations of investment property and property, plant and equipment will usually require a provision for deferred tax. Just as the revaluation gain is treated as unrealised, the deferred tax on that gain should be treated as a reduction in that unrealised gain rather than as a realised loss.

FRS 102 has introduced changes in how profit and loss is calculated, which has a direct impact on distributable reserves. Some of these changes are as follows:

- Goodwill and intangibles may be amortised more quickly using FRS 102 than under old GAAP. This increase in amortisation would reduce distributable reserves.
- Lease incentives, under FRS 102, are spread over the term of the lease, whereas under old GAAP incentives were generally spread over the period ending on the first rent review date. However, under the transitional provisions of FRS 102 for leases, which started before the date of transition to FRS 102, an entity does not have to restate or change the lease incentive period.
- For many financial instruments, fair value accounting under FRS 102 will result in the realisation of profits and losses in respect of the change in fair value of some financial instruments. This will directly affect distributable reserves for those financial instruments that can be readily converted into cash. Often financial instruments can be 'closed out' immediately (with no notice period required), which means that the change in value directly affects distributable reserves.

6. REPORTING

The company's articles and memorandum of association will need to be reviewed to ensure that the company is not prohibited from purchasing its own shares. The company's articles and memorandum have to be complied with, in addition to the statutory requirements. 'Unaltered' articles drawn up using the Companies Act 2006 will allow redemption; however, 'altered' articles or articles drawn up using the Companies Act 1985 will need to be reviewed to ensure that the company has the right to purchase its own shares.

The following conditions need to be met and documents and returns are required if a company purchases its own shares:

1. Return under CTA 2010 s1046 to be sent to HMRC as explained in section 3 ('Taxation') above.
2. The directors of a limited company (public or private company) may determine the terms, conditions and manner of redemption of shares if they are authorised to do so by the company articles or by an ordinary resolution of the company (CA 2006 s685).
3. If a limited company redeems any redeemable shares it must within one month after doing so give notice to the registrar, specifying the shares redeemed. The notice must be accompanied by a statement of capital giving details specified in CA 2006 s689.
4. Depending on the type of company and authorisation (see 2 above), a company will either require a resolution to approve an off-market purchase (CA 2006 s694). (A copy of the contract must be made available to members and comply with CA 2006 s696.)
    a. or an ordinary resolution to authorise a market purchase (CA 2006 s701)
    b. in both cases the resolution must be sent to the Registrar of Companies within 15 days (CA 2006 s30)
    c. in general, market purchases are limited to listed shares and those traded on the AIM.
5. Any contract for purchase of own shares must be retained at the company's registered office for a period of 10 years and be open to inspection without charge to any member of the company and for public companies by any other person (CA 2006 s702).
6. The Registrar of Companies must be notified within 28 days of the purchase of own shares (CA 2006 s707). The return must distinguish between treasury shares and other shares and between treasury shares that are cancelled and not cancelled.
7. The company must give notice of cancellation of shares to the registrar within 28 days specifying the shares cancelled and accompanied by a statement of capital complying with CA 2006 s708.
8. A private company may make a payment, for purchase of own shares, out of capital (CA 2006 s709). The company's directors must make a statutory declaration CA2006 s714 (specifying the amount of the permissible capital payment and confirming that the company can pay its debts as they fall due for at least one year). The declaration

must have attached to it a report by the company's auditors addressed to the directors (see Appendix 2).

9. If a company wants to make a payment out of capital for purchase of own shares, a special resolution (to be passed within one week of the directors' statement under section 714) is required under CA 2006 s716. The resolution is ineffective unless the statutory declaration and auditors' report required by the section are available for inspection by members of the company at the meeting at which the resolution is passed. A special resolution of the members (or of a class of members) of a company means a resolution passed by a majority of not less than 75% after giving notice as specified in subsection 6 of section 283 (CA 2006 s283).
10. Within the week immediately following the date of the resolution for payment out of capital, the company must publish details prescribed by CA 2006 s719 in the Gazette and either an appropriate national newspaper or inform each creditor.
11. The company must deliver to the Registrar of Companies a copy of the directors' statutory declaration and the auditors' report. These documents must also be available for inspection by members and creditors at the company's registered office (CA 2006 s720).
12. Where a private company passes a special resolution approving a payment for purchase of own shares out of capital, creditors and members can apply to the court for cancellation of the resolution. If an application is made, the company shall give notice and send a copy of the court order to the Registrar of Companies (CA 2006 s722).

Forms to be filed at Companies House can be found at the following address:
https://www.gov.uk/government/collections/companies-house-forms-for-limited-companies

The following forms relate to purchase of own shares:

- SH03 Return of purchase of own shares
- SH06 Notice of cancellation of shares
- SH16 Notice by the applicants of application to court for cancellation of the special resolution approving a redemption or purchase of shares out of capital

- SH17 Notice by the company of application to court for cancellation of the special resolution approving a redemption or purchase of shares out of capital.

7. GENERAL BUSINESS PLANNING ISSUES

When a company purchases its own shares from a shareholder there are at least two business planning issues to bear in mind, which are:

1. The company will be paying for the shares. This will usually be in money from the bank account; however, it may be in the form of assets. ACCA's website has a section looking at business finance and specifically deals with types of finance, the right finance for your business, business plans and applying for finance. This can be found at http://www.accaglobal.com/en/business-finance.html.
2. The shareholder who is selling their shares to the company may be a director and/or employee. When the shares are sold to the company the ex-shareholder may also cease working for the company, taking away skills, experience and possibly business contacts.

If the intention is for the company to continue then it should ensure that it can survive both of these events and thrive in the future. The intention may be for the company to cease trading and possibly to be wound up, in which case purchase of its own shares or reduction of capital may be a preliminary step before that process occurs.

8. ETHICAL CONSIDERATIONS FOR THE ADVISER

Ethical matters will need to be considered if the accountant (internal or external) is advising both the company buying the shares and the shareholder selling the shares. The company will usually try to achieve as low a price as possible for the shares, whereas the shareholder will try to achieve as high a price as possible. This may lead to a conflict between the interests of the different parties, particularly when the adviser is involved in the share valuation.

The *ACCA Rulebook* gives guidance on this, which, for 2018, is in section 220, pages 302 to 309: 'Conflicts of Interest'. In particular, safeguards can usually be implemented to overcome these conflicts, such as notifying all known relevant parties that the professional accountant in public practice is acting for two or more parties in respect of a matter where their respective interests are in conflict, and obtaining their consent to so act.

The *ACCA Rulebook 2018* can be found at

http://www.accaglobal.com/us/en/member/standards/rules-and-standards/rulebook.html

APPENDIX 1

SUMMARY OF THE LAW RELATING TO COMPANY BUY BACK OF OWN SHARES

The Companies Act 2006 has a section dealing with the acquisition by a company of its own shares, which is in Part 18 sections 658 to 737. These sections were implemented on 1 October 2009. The Companies Act 2006 can be found at http://www.legislation.gov.uk/ukpga/2006/46/contents.

These sections were amended by Statutory Instrument 2013 no. 999 with effect from 30 April 2013, which can be found at http://www.legislation.gov.uk/uksi/2013/999/pdfs/uksi_20130999_en.pdf.

Companies Act 2006

'Reduction of capital' is dealt with in sections 641 to 653 of the Companies Act 2006.

'Purchase of own shares' is dealt with in sections 690 to 708 of the Companies Act 2006. Sections 709 to 723 deal with 'redemption or purchase by private company out of capital'. The main points in these sections are summarised below.

Section 690

A limited company having share capital may purchase its own shares if not prohibited by the company's articles unless if, after the purchase, there would no longer be any issued shares of the company other than redeemable shares or shares held as treasury shares.

Section 691

A limited company may not purchase its own shares unless they are fully paid. Where a limited company purchases its own shares, the shares must be paid for on purchase, unless a private company is purchasing the shares in relation to an employees' share scheme.

Section 692

1. A private limited company may purchase its own shares:
    a. out of capital in accordance with chapter 5, (ie sections 709 to 723) and

b. with cash (if authorised to do so by its articles) up to an amount in a financial year not exceeding the lower of

i £15,000, or

ii the nominal value of 5% of its share capital.

2. Subject to subsection 1,

a. a limited company may only purchase its own shares out of:

i distributable profits of the company, or

ii the proceeds of a fresh issue of shares made for the purpose of financing the purchase, and

b. any premium payable on the purchase by a limited company of its own shares must be paid out of distributable profits of the company, subject to subsection 3.

3. If the shares to be purchased were issued at a premium, any premium payable on their purchase by the company may be paid out of the proceeds of a fresh issue of shares made for the purpose of financing the purchase, up to an amount equal to:

a. the aggregate of the premiums received by the company on the issue of the shares purchased, or

b. the current amount of the company's share premium account (including any sum transferred to that account in respect of premiums on the new shares),

whichever is the less.

4. The amount of the company's share premium account is reduced by the sum corresponding (or by sums in the aggregate corresponding) to the amount of any payment made under subsection 3 above.

Under section 735, if the company is wound up and at the commencement of the winding up, the company either:

a. has issued shares on terms that they are or are liable to be redeemed, or

b. has agreed to purchase any of its shares.

Then, if any of those shares in (a) or (b) above have not been redeemed or purchased, the terms of redemption or purchase may be enforced against the company.

Section 693

A limited company may only purchase its own shares:

a. by an off-market purchase authorised in accordance with section 693A or, in pursuance of a contract approved in advance in accordance with section 694,
b. by a market purchase, authorised in accordance with section 701.

A purchase is a ‘market purchase’ if it is made on a recognised investment exchange.

‘693A Authority for off-market purchase for the purposes of or pursuant to an employees’ share scheme

1. A company may make an off-market purchase of its own shares for the purposes of or pursuant to an employees’ share scheme if the purchase has first been authorised by a resolution of the company under this section.
2. That authority:
   a. may be general or limited to the purchase of shares of a particular class or description, and
   b. may be unconditional or subject to conditions.
3. The authority must:
   a. specify the maximum number of shares authorised to be acquired, and
   b. determine both the maximum and minimum prices that may be paid for the shares.
4. The authority may be varied, revoked or from time to time renewed by a resolution of the company.
5. A resolution conferring, varying or renewing authority must specify a date on which it is to expire, which must not be later than five years after the date on which the resolution is passed.
6. A company may make a purchase of its own shares after the expiry of the time limit specified if:
   a. the contract of purchase was concluded before the authority expired, and
   b. the terms of the authority permitted the company to make a contract of purchase that would or might be executed wholly or partly after its expiration.
7. A resolution to confer or vary authority under this section may determine the maximum or minimum price for purchase by:

a. specifying a particular sum, or
b. providing a basis or formula for calculating the amount of the price (but without reference to any person's discretion or opinion).

8. Chapter 3 of Part 3 (resolutions affecting a company's constitution) applies to a resolution under this section.'

Section 694

Subject to section 693A, a company may only make an off-market purchase of its own shares in pursuance of a contract approved prior to the purchase in accordance with this section.

Either

a. the terms of the contract must be authorised by a resolution of the company before the contract is entered into, or
b. the contract must provide that no shares may be purchased in pursuance of the contract until its terms have been authorised by a resolution of the company.

Subsections 3 to 6 contain provisions relating to off-market purchase.

Sections 695 to 700

Sections 695 to 700 also relate to 'off-market purchase' and explain the resolutions required and disclosure of information to members.

Section 701

Section 701 relates to 'authority for market purchase' as referred to in section 693.

Sections 702 and 703

Sections 702 and 703 relate to rights to inspect copy of contract (for off-market purchase or market purchase) or memorandum setting out the contract terms.

Section 704

The rights of a company under a contract authorised under section 693A, section 694 or 701 are not capable of being assigned.

Section 705

Section 705 refers to acquiring rights, variation of contracts and release of obligations. If a company makes payment relating to these events such payment must be made out of the company's distributable profits.

Section 706

Where a limited company makes a purchase of its own shares in accordance with sections 690 to 708 then:

a. if treasury shares (see sections 724 to 732), the shares may be held and dealt with in accordance with sections 724 to 732
b. for other shares, the shares are treated as cancelled and the amount of the company's issued share capital is diminished by the nominal value of the shares cancelled.

Section 707: Return to registrar of purchase of own shares

Where a company purchases shares in accordance with sections 690 to 708, it must deliver a return to the registrar within the period of 28 days beginning with the date on which the shares are delivered to it.

The return must

a. distinguish between treasury shares and other shares
b. distinguish between treasury shares that are cancelled and not cancelled
c. state, with respect to shares of each class purchased, the number and nominal value of the shares and the date on which they were delivered to the company
d. for a public company, also state the aggregate amount paid by the company for the shares and the maximum and minimum prices paid in respect of shares of each class purchased.

Particulars of shares delivered to the company on different dates and under different contracts may be included in a single return. In such a case, the aggregate amount required to be stated under paragraph (d) above is the aggregate amount paid by the company for all the shares to which the return relates.

Section 708: Notice to registrar of cancellation of shares

Where a company purchases any of its own shares and those shares are cancelled, the company must give notice of cancellation to the registrar within the period of 28 days beginning with the date on which the shares are delivered to it, specifying the shares cancelled.

The notice must be accompanied by a statement of capital stating with respect to the company's share capital immediately following the cancellation:

a. the total number of shares of the company
b. the aggregate nominal value of those shares
c. for each class of shares
    i. prescribed particulars of the rights attached to the shares
    ii. the total number of shares of that class
    iii. the aggregate nominal value of shares of that class, and
d. the amount paid up and the amount (if any) unpaid on each share (whether on account of the nominal value of the share or by way of premium).

Sections 709 to 723

Sections 709 to 723 relate to private company redemption or purchase own shares out of capital.

Section 709

Subject to any restriction or prohibition in the company's articles, a private company may, in accordance with sections 709 to 723, make a payment in respect of the redemption or purchase of its own shares otherwise than out of distributable profits or the proceeds of a fresh issue of shares.

Section 710

The permissible capital payment is the payment that may be made by a company out of capital in respect of the redemption or purchase of its own shares is such amount as, after applying for that purpose, any available profits of the company and the proceeds of any fresh issue of shares made for the purpose of the redemption or purchase, is required to meet the price of redemption or purchase.

Sections 711 and 712

Sections 711 and 712 explain how ‘available profits’ are calculated.

Section 713

A payment out of capital by a private company for the redemption or purchase of its own shares is not lawful unless

1. the company’s directors make a statement and the auditors make a report under section 714
2. the payment is approved by special resolution under section 716
3. the company has publicised the proposed payment under section 719
4. the directors’ statement and auditor’s report are available for inspection under section 720. This is subject to section 720A and to any order of the court under section 721.

Section 714

   a. The company’s directors must make a statement in accordance with this section.
   b. The statement must specify the amount of the permissible capital payment for the shares in question.
   c. It must state that, having made full inquiry into the affairs and prospects of the company, the directors have formed the opinion:
      i. as regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts
      ii. as regards its prospects for the year immediately following that date, that having regards to
         1. their intentions with respect to the management of the company’s business during that year
         2. the amount and character of the financial resources that will in their view be available to the company during that year,

the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.

d. In forming their opinion for the purposes of subsection (c) (i), the directors must take into account all of the company's liabilities (including any contingent or prospective liabilities).
e. The directors' statement must be in the prescribed form and must contain such information with respect to the nature of the company's business as may be prescribed.
f. It must, in addition, have annexed to it a report addressed to the directors by the company's auditor stating that:
    a. he has inquired into the company's state of affairs,
    b. the amount specified in the statement as the permissible capital payment for the shares in question is in his view properly determined in accordance with sections 710 to 712, and
    c. he is not aware of anything to indicate that the opinion expressed by the directors in their statement as to any of the matters mentioned in subsection (c) above is unreasonable in all the circumstances.

Section 715

If the directors make a statement under section 714 without having reasonable grounds, an offence is committed by every director who is in default.

Section 716

1. The payment out of capital must be approved by a special resolution of the company.
2. The resolution must be passed on, or within the week immediately following, the date on which the directors make the statement required by section 714.
3. A resolution under this section is subject to:
    a. Section 717 (exercise of voting rights), and
    b. Section 718 (disclosure of directors' statement and auditors' report).

Section 717

This section restricts the voting rights attached to the shares to be redeemed.

Section 718

The directors' statement and auditor's report under section 714 should be sent to eligible members (in the case of a written resolution) or made available for inspection at the meeting at which the vote is to take place.

Section 719: public notice of proposed payment

1. Within the week immediately following the date of the resolution under section 716, the company must cause to be published in [the Gazette](#) a notice:
    a. stating that the company has approved a payment out of capital for the purpose of acquiring its own shares by redemption or purchase or both;
    b. specifying the date of the resolution and the amount of the permissible capital payment for the shares in question;
    c. stating where the directors' statement and auditor's report required by section 714 are available for inspection, and
    d. stating that any creditor of the company may at any time within the five weeks immediately following the date of the resolution apply to the court under section 721 for an order preventing the payment.
2. Within the week immediately following the date of the resolution, the company must also either:
    a. cause a notice to the same effect as that required by subsection 1 to be published in an appropriate national newspaper, or
    b. give notice in writing to that effect to each of its creditors.
3. 'An appropriate national newspaper' means a newspaper circulating throughout the part of the UK in which the company is registered.
4. Not later than the day on which the company:
    a. first publishes the notice required by subsection 1, or
    b. if earlier, first publishes or gives the notice required by subsection 2,

    the company must deliver to the registrar a copy of the directors' statement and auditor's report required by section 714.

Section 720: directors' statement and auditor's report to be available for inspection

The directors' statement and auditor's report must be kept available for inspection by any member or creditor of the company for a specified period.

720A: reduced requirements for payment out of capital for purchase of own shares for the purposes of or pursuant to an employees' share scheme

1. Section 713(1) does not apply to the purchase out of capital by a private company of its own shares for the purposes of or pursuant to an employees' share scheme when approved by special resolution supported by a solvency statement.
2. For the purposes of this section, a resolution is supported by a solvency statement if:
    a. the directors of the company make a solvency statement (see section 643) not more than 15 days before the date on which the resolution is passed, and
    b. the resolution and solvency statement are registered in accordance with section 720B.
3. Where the resolution is proposed as a written resolution, a copy of the solvency statement must be sent or submitted to every eligible member at or before the time at which the proposed resolution is sent or submitted to the member.
4. Where the resolution is proposed at a general meeting, a copy of the solvency statement must be made available for inspection by members of the company throughout that meeting.
5. The validity of a resolution is not affected by a failure to comply with subsection 3 or 4.
6. Section 717 (resolution authorising payment: exercise of voting rights) applies to a resolution under this section as it applies to a resolution under section 716.

720B: registration of resolution and supporting documents for purchase of own shares for the purposes of or pursuant to an employees' share scheme

1. Within 15 days after the passing of the resolution for a payment out of capital by a private company for the purchase of its own shares for the purposes of or pursuant to an employees' share scheme, the company must deliver to the registrar:
    a. a copy of the solvency statement,
    b. a copy of the resolution, and
    c. a statement of capital.
2. The statement of capital must state with respect to the company's share capital as reduced by the resolution:

a. the total number of shares of the company

b. the aggregate nominal value of those shares

ba. The aggregate amount (if any) unpaid on those shares (whether on account of their nominal value or by way of premium), and

c. for each class of shares:

   i. prescribed particulars of the rights attached to the shares

   ii. the total number of shares of that class

   iii. the aggregate nominal value of shares of that class

3. The registrar must register the documents delivered to him under subsection 1 on receipt.
4. The resolution does not take effect until those documents are registered.
5. The company must also deliver to the registrar, within 15 days after the resolution is passed, a statement by the directors confirming that the solvency statement was:
   a. made not more than 15 days before the date on which the resolution was passed, and
   b. provided to members in accordance with section 720A(3) or (4).
6. The validity of a resolution is not affected by:
   a. a failure to deliver the documents required to be delivered to the registrar under subsection 1 within the time specified in that subsection, or
   b. a failure to comply with subsection 5.
7. If the company delivers to the registrar a solvency statement that was not provided to members in accordance with section 720A(3) or (4), an offence is committed by every officer of the company who is in default.
8. If default is made in complying with this section, an offence is committed by:
   a. the company, and
   b. every officer of the company who is in default.
9. A person guilty of an offence under subsection 7 or 8 is liable:
   a. on conviction on indictment, to a fine
   b. on summary conviction, to a fine not exceeding the statutory maximum.

APPENDIX 2

Extract from the Auditing Practices Board bulletin 2008/9, 'Report when a private company wishes to redeem or purchase its own shares out of capital (Section 714(6) of CA 2006) effective 1 October 2009

A payment out of capital by a private company for the redemption or purchase of its own shares is not lawful unless the requirements of sections 714, 716, 719, 720 and 721 of CA 2006 are met. Section 716 of CA 2006 requires that a payment out of capital must be approved by special resolution which must be passed on, or within the week immediately following, the date on which the directors make the statement required by section 714 of CA 2006.

Directors' statement

To make a payment out of capital the directors are required by sections 714(1) to (5) of CA 2006 to make a statement specifying the amount of the permissible capital payment for the shares in question. Section 714(3) requires the directors to state that, having made full inquiry into the affairs and prospects of the company, the directors have formed the opinion:

a. as regards its initial situation immediately following the date on which the payment out of capital is proposed to be made, that there will be no grounds on which the company could then be found unable to pay its debts, and
b. as regards its prospects for the year immediately following that date, that having regard to:
    i. their intentions with respect to the management of the company's business during that year, and
    ii. the amount and character of the financial resources that will in their view be available to the company during that year,
    iii. the company will be able to continue to carry on business as a going concern (and will accordingly be able to pay its debts as they fall due) throughout that year.

In forming their opinion, in respect of paragraph 58(a) above, the directors are required to take into account all of the company's liabilities (including any contingent or prospective liabilities).

The permissible capital payment (section 710 of CA 2006)

The payment that may be made out of capital is described as the 'permissible capital payment' and is such amount as, after applying:

a. any available profits of the company and
b. the proceeds of any fresh issue of shares made for the purposes of the redemption or purchase,

is required to meet the price of redemption or purchase.

Determination of available profits (sections 711 and 712 of CA 2006)

The available profits of the company are determined as follows:

1. First, determine the profits of the company by reference to the following items as stated in the relevant accounts (see paragraph 62):
    a. profits, losses, assets and liabilities
    b. provisions of the following kinds:
        i. where the relevant accounts are Companies Act accounts, provisions of a kind specified for the purposes of this subsection by regulations under section 396 of CA 2006
        ii. where the relevant accounts are IAS accounts, provisions of any kind
        iii. share capital and reserves (including undistributable reserves).
2. Second, reduce the amount so determined by the amount of:
    a. any distribution lawfully made by the company, and
    b. any other relevant payment lawfully made by the company out of distributable profits, after the date of the relevant accounts and before the end of the relevant period (see paragraph 62).
3. The resulting figure is the amount of available profits.

The ‘relevant accounts’ are any accounts that:

a. are prepared as at a date within the relevant period, and
b. are such as to enable a reasonable judgment to be made as to the amounts of the items mentioned under ‘1’.

The ‘relevant period’ means the period of three months ending with the date on which the directors’ statement is made in accordance with section 714 of CA 2006.

Report by the company’s auditor

The directors’ statement is required by section 714(6) to have annexed to it a report addressed to the directors by the company’s auditor (see example on page 37), stating that:

a. it has inquired into the company’s state of affairs,
b. the amount specified in the statement as the permissible capital payment for the shares in question is in its view properly determined in accordance with sections 710 to 712 of CA 2006, and
c. it is not aware of anything to indicate that the opinion expressed by the directors in their statement as to any of the matters mentioned in subsection (3) of section 714 of CA 2006 is unreasonable in all the circumstances.

The directors’ statement and therefore the annexed auditor’s report are required to be made in the week before the resolution is passed specifying the amount of the permissible capital payment for the shares in question. The auditor’s report cannot be dated earlier than the date of the director’s statement to which it relates. The date of the auditor’s report is the date on which the auditor signs its report expressing its opinion.

There is no provision for the auditor’s report to be other than unqualified. Unless the opinion is unqualified the auditor does not issue a report.

REPORT WHEN A PRIVATE COMPANY WISHES TO REDEEM OR PURCHASE ITS OWN SHARES OUT OF CAPITAL

Effective 1 October 2009

REPORT OF THE INDEPENDENT AUDITOR TO THE DIRECTORS OF XYZ LIMITED PURSUANT TO SECTION 714(6) OF THE COMPANIES ACT 2006

We report on the attached statement of the directors dated..., prepared pursuant to the Companies Act 2006, in connection with the company's proposed [purchase]/[redemption] of... (number) [ordinary]/[preferred] shares by a payment out of capital.

Basis of opinion

We have inquired into the company's state of affairs in order to review the bases for the directors' statement.

Opinion

In our opinion the amount of £... specified in the directors' statement as the permissible capital payment for the shares to be [purchased]/[redeemed] is properly determined in accordance with sections 710 to 712 of the Companies Act 2006.

We are not aware of anything to indicate that the opinion expressed by the directors in their statement as to any of the matters mentioned in section 714(3) of the Companies Act 2006 is unreasonable in all the circumstances.

Statutory auditor

Address

Date

APPENDIX 3

Worked examples of accounting entries

1. Simple buy back at par value

A company has the following balance sheet:	£
Cash at bank	25,000
Ordinary £1 shares	15,000
Profit and loss account	10,000
	25,000

A decision is made to buy back 3,750 ordinary £1 shares at par.
The entries would be as follows:

	DR	CR
	£	£
Ordinary share capital	3,750	
Bank account		3,750
To redeem the shares		
Profit and loss account reserve	3,750	
Capital redemption reserve		3,750
To maintain the capital at its original amount		

The balance sheet will now be:	£
Cash at bank	21,250
Ordinary £1 shares	11,250
Capital redemption reserve	3,750
Profit and loss account	6,250
	21,250

If there had been a fresh issue of shares, the second journal to maintain the capital would not have been necessary, except to the extent that the fresh issue fell short of £3,750.

2. Redemption at a premium

If the above transaction had not been at par, but was instead at a premium of 20p per share, the entries would be as follows:

	DR	CR
	£	£
Ordinary share capital	3,750	
Profit and loss reserve	750	
Bank account		4,500
To redeem the shares		
Profit and loss reserve	3,750	
Capital redemption reserve		3,750
To maintain the capital at its original amount		

The balance sheet will now be:	£
Cash at bank	
	20,500
Ordinary £1 shares	11,250
Capital redemption reserve	3,750
Profit and loss account	5,500
	20,500

3. Redemption at a premium and shares issued at a premium

A company has the following balance sheet:	£
Cash at bank	28,000
Ordinary £1 shares	10,000
Redeemable preference £1 shares	4,000
Share premium account	1,800
Profit and loss account	12,200
	28,000

The decision was made to redeem all the preference shares with a redemption premium of 25p per share. The preference shares were originally issued at a premium of 20p per share. The company also plans to make a fresh issue of 2,000 ordinary shares at £1.50 per share.

The entries would be as follows:

	DR £	CR £
Cash	3,000	
Ordinary £1 shares		2,000
Share premium account		1,000
To record the new issue		
Preference shares	4,000	
Share premium account	800	
Profit and loss reserve	200	
Cash		5,000
To redeem the shares		
Profit and loss reserve	1,800	
Capital redemption reserve		1,800
To maintain the capital		

The balance sheet would now be:	£
Cash at bank	
	26,000
Ordinary £1 shares	12,000
Share premium account	2,000
Capital redemption reserve	1,800
Profit and loss reserve	10,200
	26,000

The amount of the share premium on the new issue, as restricted by the amount included in the share premium account from the original issue of the redeemable shares, can be released to set against the premium payable on redemption, thus reducing the amount to be debited to distributable reserves. The amount of the adjustment required to maintain capital is the amount that the proceeds of the new issue fell short of the nominal value of the shares redeemed, as adjusted for the amount already applied towards the redemption (£4,000-£3,000+£800).

4. Redemption when insufficient reserves

A (private) company has the following balance sheet:

	£
Cash at bank	15,000
Ordinary £1 shares	14,000
Profit and loss reserve	1,000
	15,000

The decision is made to buy back 7,000 ordinary £1 shares at par. The distributable reserves are insufficient to allow this without a permissible capital payment. The procedures set out in the Companies Act have to be followed, and then the journal entries would be as follows:

	£	£
Share capital	7,000	
Cash at bank		7,000
To effect the redemption		
Profit and loss reserve	1,000	
Capital redemption reserve		1,000
To maintain the capital as far as possible		

Afterwards the balance sheet will look like this:

	£
Cash at bank	8,000
Ordinary £1 shares	7,000
Capital redemption reserve	1,000
	8,000

In examples 1 to 3 above the share capital and undistributable reserves total to the same amount after the buy back as they did before, which is due to there being sufficient reserves to maintain the capital by virtue of a capital redemption reserve. In example 4 the total has reduced by £6,000 from £14,000 to £8,000. This £6,000 is the amount of the permissible capital payment which is equal to the shortfall on the profit and loss account reserves before the redemption.

5. Issue of new shares and redemption

A private company has the following balance sheet:

	£
Cash at bank	3,500
Ordinary £1 shares	2,000
Share premium account	0
Profit and loss account	1,500
	3,500

The decision is made to buy back 300 ordinary £1 shares for £2 each (£600 in total), which were originally issued for £1.50 each (£450 in total). The company is to issue 1,000 new ordinary £1 shares for £1.20 each (£1,200 in total). The share premium account that arose on the original issue of the shares now being redeemed or bought back was used some time ago to fund a bonus issue of shares. The journal entries for the new issue and buy back would be as follows:

	£	£
Share capital		1,000
Share premium account		200
Cash at bank	1,200	
To effect the new issue		
Share capital	300	
Share premium account	200	
Profit and loss reserve	100	
Cash at bank		600
To effect the buy back of shares		

Afterwards, the balance sheet will look like this:

	£
Cash at bank	4,100
Ordinary £1 shares	2,700
Profit and loss account	1,400
	4,100

6. Permissible capital payments (no new issue of shares)

A private company has the following balance sheet:	£
Cash at bank	13,000
Ordinary £1 shares	14,000
Profit and loss account	(1,000)
	13,000

The decision is made to buy back 7,000 ordinary £1 shares for £0.50 each (£3,500 in total), which were originally issued at par. The company has no distributable profits.

The relevant calculations are as follows:

	£
Cost of purchase	3,500
Less: distributable profits	nil
Less: proceeds of fresh issue	nil
Permissible capital payment	3,500
Nominal value of purchase	7,000
Less: proceeds of fresh issue	nil
Less: permissible capital payment	3,500
Transfer to capital redemption reserve	3,500

The journal entries for the buy back would be as follows:

	DR	CR
	£	£
Share capital	7,000	
Capital redemption reserve		3,500
Cash at bank		3,500

Afterwards, the balance sheet will look like this:	£
Cash at bank	9,500
Ordinary £1 shares	7,000
Capital redemption reserve	3,500
Profit and loss account	(1,000)
	9,500

7. Permissible capital payments (with new issue of shares)

A private company has the following balance sheet:	£
Cash at bank	18,000
Ordinary £1 shares	10,000
Share premium account	5,000
Profit and loss account	3,000
	18,000

The decision is made to buy back 5,000 ordinary £1 shares for £1.40 each (£7,000 in total), which were originally issued at par. The company is to issue 1,000 new ordinary £1 shares for £3.50 each (£3,500 in total).

The relevant calculations are as follows:

	£
Cost of purchase	7,000
Less: distributable profits	(3,000)
Less: proceeds of fresh issue	(3,500)
Permissible capital payment	500
Nominal value of purchase	
	5,000
Less: proceeds of fresh issue	(3,500)
Less: permissible capital payment	500
Transfer to capital redemption reserve	1,000

The journal entries for the new issue and buy back would be as follows:

	DR £	CR £
Share capital	1,000	
Share premium account	2,500	
Cash at bank		3,500
To effect the new issue		
Share capital	5,000	
Profit and loss account	2,000	
Cash at bank		7,000
Profit and loss account	1,000	
Capital redemption reserve		1,000
To effect the buy back of shares		

Afterwards, the balance sheet will look like this:	£
Cash at bank	14,500
Ordinary £1 shares	6,000
Share premium account	7,500
Capital redemption reserve	1,000
Profit and loss account	nil
	14,500

8. Reduction of capital

A private company has the following balance sheet:	£
Cash at bank	18,000
Ordinary £1 shares	10,000
Share premium account	5,000
Profit and loss account	3,000
	18,000

The share premium account arose when the ordinary shares were issued for £1.50 each. The decision is made to reduce the ordinary shares by £8,000 and to reduce the share premium account by £4,000 because the company is over capitalised. The proper procedure needs to be followed and then the journal entries would be as follows:

	DR £	CR £
Ordinary £1 shares	8,000	
Share premium account	4,000	
Profit and loss account		12,000

Afterwards the balance sheet will look like this:	£
Cash at bank	18,000
Ordinary £1 shares	2,000
Share premium account	1,000
Profit and loss account	15,000
	18,000

APPENDIX 4

Example of an ordinary resolution and notice of ordinary resolution

Section 307 Companies Act 2006

A general meeting of a private company (other than an adjourned meeting) must be called by notice of at least 14 days.

A general meeting of a public company (other than an adjourned meeting) must be called by notice of at least 21 days for an annual general meeting and in any other case, at least 14 days.

The company's articles may require a longer period of notice. A general meeting may be called by shorter notice than that otherwise required if shorter notice is agreed by the members.

Example of ordinary resolution and notice of ordinary resolution

Notice is hereby given that a general meeting of XYZ PLC will be held at 1 High Road, London W1 1AA on 1 December 2016 to consider and if deemed fit to approve the following resolution:

ORDINARY RESOLUTION

That the members of XYZ PLC authorise the company, pursuant to section 694 Companies Act 2006, to make an off-market purchase of 10,000 of its ordinary shares at a price of £4 per share. The company is authorised to make the purchase any time from the close of this meeting to 31 January 2017 inclusive.

Dated this 31 October 2016

By order of the Board

And XYZ PLC at (Registered Office)

Signed …………………………………

Company Secretary

APPENDIX 5

Extract from HMRC publication SP2/82: company's purchase of own shares

HMRC Statement of Practice 2/82 (SP2/82) refers to ICTA 1988 sections 212 to 232

These sections have been replaced by CTA 2010 sections 1029 to 1063.

SP2/82 Company's purchase of own shares: ICTA 1988 (See also Inland Revenue Tax Bulletin, Issue 21, February 1996, page 280)

Where a company makes a purchase of own shares which involves a payment in excess of the capital originally subscribed for the shares, the excess constitutes a distribution. However, such a payment is treated as not giving rise to a distribution if, among other conditions, the purchase is made wholly or mainly to benefit a trade carried on by the company, or by one of its 75% subsidiaries. This Statement indicates how this test is applied by HM Revenue and Customs.

The Annex to this Statement gives guidance on how companies should apply for a ruling on whether or not a purchase will be treated as a distribution.

Section 219(1)(a) – the 'Trade Benefit Test'

1. The Company's sole or main purpose in making the payment must be to benefit a trade carried on by it or by its 75% subsidiary. The condition is not satisfied where, for example, the transaction is designed to serve the personal or wider commercial interests of the vending shareholder (although usually he will benefit from it) or where the intended benefit for the company is to some non-trading activity which it also carries on.
2. If there is a disagreement between the shareholders over the management of the company and that disagreement is having or is expected to have an adverse effect on the company's trade, then the purchase will be regarded as satisfying the trade benefit test provided the effect of the transaction is to remove the dissenting shareholder entirely. Similarly, if the purpose is to ensure that an unwilling shareholder who wishes to end his association with the company does not sell his shares to someone who might not be acceptable to the other shareholders, 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 (whether or not with the expectation of redemption or sale to the company) and who now wishes to withdraw that finance
- a controlling shareholder who is retiring as a director and wishes to make way for new management
- personal representatives of a deceased shareholder, where they wish to realise the value of the shares
- a legatee of a deceased shareholder, where he does not wish to hold shares in the company.

3. If the company is not buying all the shares owned by the vendor, or if although the vendor is selling all his shares he is retaining some other connection with the company – for example, a directorship or an appointment as consultant – it would seem unlikely that the transaction could benefit the company's trade, so the trade benefit test will probably not be satisfied. However, there are exceptions: for example, where a company does not currently 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. In these circumstances, it may still be possible for the company to show that the main purpose is to benefit its trade. Also, the Commissioners for Her Majesty's Revenue and Customs do not raise any objection if for sentimental reasons it is desired that a retiring director of a company should retain a small shareholding in it, not exceeding 5% of the issued share capital.

Annex to SP2/82

Applications for advance clearance under Section 1044 CTA 2010

Procedure

If clearance under S.1044 is desired, the application should be sent to:

Counter-Avoidance Clearance SO528
PO Box 194
Bootle L69 9AA

Email: reconstructions@hmrc.gsi.gov.uk

Further details can be found at
www.gov.uk/government/publications/seeking-clearance-or-approval-for-a-transaction

If clearance is also being sought under Section 707, ICTA 1988, a single application may be made under both provisions and should be directed to the address given above **with an extra copy of the application and enclosures**. Such an application should open by stating clearly the provisions under which it is made and should be expanded to include any additional information needed for the application under the other provision.

Form of application: general

Sections 219-229 contain conditions which must be satisfied before the tax treatment afforded by S.219 can apply. A comprehensive application which has regard to each of these conditions will remove the need for lengthy fact-finding enquiries and enable the commissioners for Her Majesty's Revenue and Customs to come to a decision on the application with the minimum of delay.

To assist companies in preparing clearance applications under Section 225 and to facilitate their consideration by the Commissioners for Her Majesty's Revenue and Customs, an outline of the basic information needed is given below. However, it is not an exhaustive list, and in giving the particulars of the relevant transactions required by Section 225(2) the applicant must fully and accurately disclose all facts and circumstances material for the decision of the Commissioners for Her Majesty's Revenue and Customs (Section 225(5)).

In what follows, references to purchase of shares include references to repayment or redemption of shares.

It will be helpful if applications follow the order set out below, each item being expanded as necessary and any further information being added at the end.

Application for clearance under Section 225(1)(a)

It should be stated at the outset whether the purchase of shares is regarded as falling within Section 219(1) by virtue of (a) or (b). If the purchasing company has previously made any application under Section 225 it will be helpful if the Commissioners for Her Majesty's Revenue and Custom's reference(s) can be quoted.

A. Purchases within Section 219(1)(a)

1. The company

- a. the name of the company making the purchase
- b. its Tax District and reference
- c. confirmation that it is an unquoted company as defined in Section 229(1)
- d. its status, that is, 'trading company' or 'holding company of a trading group' within the Section 229(1) definitions or some other type of company not within the definitions.

2. Groups

Where the company is a member of a group (see below):

- a. the names of the group companies together with their tax districts and references:
- b. a statement or diagram showing the shareholding interests of each group company in other group companies.

A group for the purpose of this paragraph is the largest 51% group to which the purchasing company belongs (Section 222(9)), but the meaning of 'group' is extended, where appropriate, by Section 222(10)) and (12).

3. The payment

- a. details of the shares to be purchased the name of their present owner, the purchase price and the method of payment
- b. details of any other transactions between the company and the vendor at or about the same time
- c. confirmation that the company's Articles of Association allow it to purchase its own shares.

4. Shareholders

a. a list of the current shareholders in the purchasing company, and, where appropriate, in each company in a group as in 2 above, together with particulars (amount, class, dividend rights etc) of their current holdings

b. a statement of any relationships of the shareholders to each other

c. where the shareholder is the son or daughter of another shareholder, an indication that he or she is over 18 or else details of their age.

5. Prior transactions

Particulars of any prior transactions or rearrangements to be carried out in preparation for the purchase.

6. Purpose and benefits

A statement of the reasons for the purchase, the trading benefits expected and any other benefits expected to accrue, whether or not to the purchasing company.

7. Conditions in Section 219

Confirmation, together with all relevant information, that the purchase etc does not form part of a scheme or arrangement the main purpose or one of the main purposes of which is to enable the owner of the shares to participate in the profits of the company without receiving a dividend, or the avoidance of tax. Confirmation that the vendor will receive no other payment from the company, or details of any such payment to be made.

8. Conditions in Sections 220-224

a. the present residence status of the vendor and any intended change (Section 220)

b. the tax district, reference and national insurance number of the vendor, or if not known his or her private address (Section 220)

c. the period of beneficial ownership by the vendor of the shares to be purchased (Section 220(5))

d. confirmation, if appropriate, that the vendor's interest will be ‘substantially reduced’ Section 221(1))

e. confirmation, if appropriate, that the combined interests as shareholders of the vendor and his ‘associates’ (see Section 227) will be substantially reduced (Section 221(2))

f. confirmation, if appropriate, that the vendor's interest as a shareholder in the group will be substantially reduced (Section 222(1))

g. confirmation, if appropriate, that the combined interests as shareholders in the group of the vendor and his associates will be substantially reduced (Section 222(3))

h. confirmation that the vendor will not, immediately after the purchase, be ‘connected with’ (see Section 228) the company making the purchase or with any company which is a member of the same group as that company (Section 223(1))

i. confirmation that the purchase is not part of a scheme or arrangement within Section 223(2).

9. Accounts and other financial information

The application should be accompanied by:

a. copies of the latest available financial statements for the purchasing company and for any group companies (see paragraph 2 above), and in the case of a group the financial statements for the group

b. a note of any material relevant changes since the balance sheet date or confirmation that there are none

c. details of any loan or current account which the vendor maintains with the company or with any group company.

B. Purchase within Section 219(1)(b)

1. Company

a. the name of the company making the purchase

b. its Tax District and reference

c. confirmation that it is unquoted as defined in Section 229(1)

d. its status, ie 'trading company' or 'the holding company of a trading group' within the definitions in Sections 229(1), or some other type of company not within the definitions.

2. Groups

Where the company is a member of a group (see A.2 above):

a. the names of the group companies together with their tax districts and references

b. a statement or diagram showing the shareholding interests of each group company in other group companies.

3. The payment

a. details of the shares to be purchased, the name of the present owner, the purchase price and method of payment

b. details of any other transactions between the company and the vendor at or about the same time

c. confirmation that the company's articles of association allow it to purchase its own shares.

4. Inheritance tax

a. the name and date of death of the deceased

b the reference of the deceased at the Capital Taxes Office

c. the amount of the outstanding tax and whether or not liability has been finally agreed

d. the extent to which the purchase price is to be applied in satisfaction of the tax liability

e. a full explanation of the circumstances in which there would be ‘undue hardship’ if the tax liability were to be discharged otherwise than through the purchase of own shares from this or another such company
f. the tax district and reference of the person to whom undue hardship would be caused or if not known the address of that person, and their national insurance number.

5. Accounts and other financial information

The application should be accompanied by:

a. copies of the latest available financial statements for the purchasing company and for any group companies (see paragraph A.2 above), and in the case of a group the financial statements for the group
b. a note of any material relevant changes since the balance sheet date or confirmation that there are none.

Applications for clearance under Section 225(1)(b)

1. Company

a. the name of the company making the purchase
b. its tax district and reference.

2. The payment

a. details of the shares to be purchased, the vendor, the purchase price and the method of payment
b. confirmation that the company's articles of association allow it to purchase its own shares.

3. Account and other financial information

a. copies of the latest available financial statements for the purchasing company
b. a note of any material relevant changes since the balance sheet date or confirmation that there are none.

4. A statement of the reasons why it is believed that the proposed payment does not fall within the provisions of Section 219.

APPENDIX 6

Excerpt from *Tax Bulletin 21*

HMRC issued the following guidance in *Tax Bulletin 21*, which is still relevant

Purchase by an unquoted company of its own shares

As a general principle, where a company makes a purchase of its own shares (a ‘PoS’), any excess paid over the amount of capital originally subscribed for the shares is a distribution. However, under Section 219 Income and Corporation Taxes Act (ICTA) 1988, where none of the company's shares are listed in the Stock Exchange Official List the excess is not treated as a distribution if various conditions are satisfied.

Under Section 225 ICTA 1988 companies intending to make a PoS can request the Board of Inland Revenue to say in advance whether they are satisfied that Section 219 ICTA 1988 will apply (or that it will not apply) to any such excess. If the Board indicate that they are satisfied, that statement is ordinarily binding on the Revenue. Thus a clearance enables the company to know whether or not it will need to account for ACT on the excess. In most cases both the company and the vendor hope to obtain Section 219 ICTA 1988 treatment, but sometimes distribution treatment is found to be advantageous.

The procedure for obtaining clearance from the Board is set out in the Annex to Statement of Practice 2/82, which was revised in 1994 and can be found in its new form in the booklet IR131 ‘Inland Revenue Statements of Practice’. The following notes deal with various matters which we find are sometimes overlooked or misunderstood.

- The Board can only consider a request relating to a transaction which appears to be a valid PoS. The Companies Act 1985 lays down certain procedural rules which must be followed. Also, the consideration for the shares must be paid immediately and must be paid in money. The first of these requirements means that payment by instalments is not possible. It is, however, possible to make a contract under which successive tranches of shares are to be purchased on specified dates.

- One simple rule which is often forgotten is that under Section 220 ICTA 1988 the shares must have been held for five years. There are relaxations where, for example, the vendor acquired the shares under the will of the previous owner, or in exchange for other shares as part of a company reconstruction. But those exceptions apart, if it is less than five years since the company was incorporated, the rule cannot be satisfied and Section 219 ICTA 1988 cannot apply.
- Another rule which is sometimes overlooked is that Section 219 ICTA 1988 can only apply if the company is a 'trading company', which is defined in Section 229 ICTA 1988 as a company whose business consists wholly or mainly of carrying on a trade. (Alternatively it can be a member of a trading group, in which case the businesses carried on must in aggregate consist wholly or mainly of trades). As the definition itself implies, not every business is a trade – for example, property investment is not a trade. Furthermore, for this particular purpose trading does not include dealing in shares, securities, land or futures. Finally, it is not enough that the company used to be, or hopes to be, a trading company; it must be one when the PoS takes place.
- For Section 219 ICTA 1988 to apply it is necessary (except in the special circumstances mentioned in Section 219(1)(b)) for the PoS to have the main purpose of benefiting a trade carried on by the company (or its subsidiary). Guidance on the Board's view of this requirement can be found in SP2/82.

In many cases the benefit in view is of such a nature that it can only be secured if the shareholder is bought out completely. Even where that is not the case, it is still necessary to ensure that the number of shares purchased is such that two arithmetical tests are met. First, the percentage of share capital held by the vendor (and his associates) immediately after the purchase must be less than three quarters of the percentage held immediately before it (see Section 221). Secondly, following the purchase the vendor (and his associates) must not be 'connected' with the company as defined in Section 228 ICTA 1988 – that is, broadly, must not have interests in the company totalling more than 30%.

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 why that should not happen. However, it should be remembered that after the PoS the shareholder's interests in the company must not exceed 30%; 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 3,000 out of the 10,000 issued £1 shares of a company.

It is agreed that the company will buy the shares for £50,000, which is their market value, and that Norman will then lend the company £25,000.

But this would mean that Norman held loan capital of £25,000 out of the company's combined share and loan capital of £32,000, so he would be connected with the company, and both parties are agreed that they would prefer the transaction to come within Section 219.

So, before making the PoS, the company makes a bonus issue of nine shares for each one held.

Norman then sells back his 30,000 shares for £50,000 and lends the company £25,000. He now holds loan capital of £25,000 out of the company's combined share and loan capital of £95,000, and since this is less than 30% of the whole he is not connected with the company.

Every year something like 1,500 companies request clearance from the Board for a proposed PoS. We try to give a response well within the statutory deadline of 30 days, but in some cases that response has to take the form of a request for further information. It is therefore advisable to allow a reasonable time for a decision to be reached and not to leave the application until the last moment.

Finally, Section 226 ICTA 1988 requires a company to make a ‘return’ to the Inspector dealing with its affairs if it purchases its own shares and does not treat the payment as giving rise to a distribution – that is, does not account for ACT. This must be done within

60 days after the purchase. The requirement applies whether or not clearance was requested. If clearance was requested the Inspector will have received a copy of the letter of clearance (or refusal), so all that is needed is a short letter detailing any changes from the arrangements advised to the Board and reporting the date of the transaction. If clearance was not requested, the Inspector will need to know the date of the purchase, the name of the vendor, the number of shares and the amount of the consideration, and the grounds on which it was considered that the 'trade benefit' test was satisfied.