Guide to: Share Buybacks

A share buyback is the purchase by a Company of its shares from one of its shareholders. It can offer a number of advantages over a simple share purchase by the other shareholders.

Advantages of a Share Buyback

- Using the resources of the Company to finance the transaction (particularly useful where the shareholders cannot afford to purchase the shares personally).

- The Company taking on the liability to pay Stamp Duty (which in a simple share purchase will be the liability of the purchasing individual).

- As the shares are often cancelled following a buyback each remaining shareholder's stake in the business is proportionately increased. This can avoid the risk of a third-party coming in.

While a share buyback can provide an effective exit route for a shareholder, there are, however, a number of key issues to keep in mind.

Funding

The purchase price must be paid out of either:

- the Company's 'distributable profits' – i.e. monies which could otherwise have lawfully been used by the company to pay a dividend; or

- the proceeds of a fresh issue of shares made for the purposes of financing the buyback.

  (The more complicated and rarely used procedure for buying back shares out of capital is outside the scope of this guide.)

Timing

The purchase price must be paid in full in cash at completion (the date on which the shares are bought back). It is not possible for the Company to buy back a seller's shares in full and agree to pay any part of the purchase price on deferred terms.

As an alternative structure, however, it may be possible to buy back shares in instalments through a series of fixed future sales of shares (i.e. multiple completions). However, this needs to be balanced against:

- the seller retaining a shareholding (and therefore an element of control) in the intervening period;

- the Company needing sufficient distributable reserves to afford the transaction at the point of each sale; and

- the seller's tax position (see below).

Buyback Approval and Procedure

The Company must not be prohibited from carrying out a buyback under its constitution (i.e. its articles of association, shareholders agreement etc.). A formal procedure must also be followed and certain documents must be used.

The buyback must be documented in a written contract known as an off-market purchase agreement.

The terms of the off-market purchase agreement must be approved by a resolution of a sufficient number of the Company's eligible shareholders before it is entered into. This can be passed either at a general meeting or by written resolution.

Seller's Tax Position

The seller's shares will qualify for capital gains tax treatment if certain conditions are met.

In these circumstances the buyback would not be treated as the distribution of income as a dividend (i.e. be subject to income tax), which is the default position if the conditions are not met. Capital gains tax treatment could result in the transaction being much more tax efficient for the seller depending on their tax position, particularly if they qualify for Entrepreneurs' Relief on the capital gains tax.

The buyback of shares through multiple completions (see above) can potentially undermine the seller's tax position; especially if the seller does not want to be involved in the business in the interim period.

Tax advice should be sought in relation to capital gains tax treatment and Entrepreneurs' Relief. It is usual for a clearance application to be made to HMRC to seek clarification that a buyback meets the conditions for capital gains tax treatment to apply.

Specialist Legal Advice

Failure to comply with strict company law requirements can cause a number of problems (see our earlier article for more information) and so early legal advice is essential. Our specialist corporate and commercial solicitors can work with you from the outset to consider how to structure your transaction effectively.

If a buyback is not right for you, we can work with you and your accountant on investigating alternative solutions, such as a share-for-share exchange and the introduction of a 'holding company' above the Company. This is where the 'continuing' shareholders transfer their shares to the holding company in consideration for the issue of shares in the holding company. At the same time, the seller transfers their shares for cash or loan note consideration which potentially can be paid over time.

BHW Solicitors is the leading specialist commercial law firm in Leicester and the East Midlands.

We provide the best legal, commercial and strategic advice to businesses of all types and sizes, from start-ups to household names.

T: 0116 289 7000 E: info@bhwsolicitors.com W: www.bhwsolicitors.com

1 Smith Way, Grove Park, Enderby, Leicestershire, LE19 1SX

BHW