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Briefing Note: Share Buybacks – Private Companies

Introduction

A share buyback is where a company purchases its own shares from its shareholders. A company may choose to undertake a buyback for several different reasons, one of the principle reasons being to return surplus cash to shareholders.

There are a number of strict requirements that must be complied with whenever a buyback is undertaken by a company and specialist advice (both legal and accountancy) should be taken to ensure these requirements are complied with.

This guide should not be relied upon as legal advice and you should contact us for advice on your specific circumstances.

Briefing Note
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Summary:
An introduction to share buybacks.

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Key reasons for buybacks

The key reasons for a company choosing to undertake a share buyback may include:

- **To return surplus cash to shareholders.** A company may have surplus cash as a result of outstanding profitability, the sale of a business or having cash in readiness of a potential acquisition or planned expansion that has fallen through. It is not efficient for a company to have excess cash without any planned use and shareholders are likely to want surplus cash returned to them. A buyback is one method of returning cash to shareholders.

- **To increase earnings per share.** A buyback can improve a company's price/earning ratio and thus increase the company's earnings per share. When a buyback enhances earnings per share, this should also lead to an increase in share price.

- **To increase gearing** (i.e. the company's ratio of debt to equity).

- **To provide an exit route for shareholders.** A private company may have a small number of shareholders with only one wanting to exit. In such a case there may be provisions in the company's articles preventing the shareholder from selling to a third party. If the remaining shareholders do not want to purchase the shares, the company may choose to repurchase the shares itself by way of a buyback. This way, a third party does not gain an interest in the company and the remaining shareholders do not personally have to pay any money to the exiting shareholder. A buyback can also be used to purchase shares issued to an employee under an employee incentive scheme when he ceases to be employed by the company.

Funding the buyback

In the case of a private company, a buyback must be an off-market purchase and can be funded by any of the following means:

- From distributable profits;

- From the proceeds of a fresh issue of shares made specifically for the purpose of financing the buyback;

- Out of capital (where the company has used all of its available profits); or
- With cash up to the value in any financial year of the lower of £15,000 and 5% of the company's share capital. When funding a buyback out of cash in this manner, shares must be repurchased at their nominal value.

If a premium is payable on shares to be bought back by a company, this must be paid out of distributable profits, save where the shares to be purchased were issued at a premium, in which case any premium payable on their repurchase may be paid out of the proceeds of a fresh issue of shares, up to certain amount.

Shares bought by a company as part of a buyback, other than for the purposes of or pursuant to an employees' share scheme must be paid for at the time they are purchased. This means that it is not possible for the payment to be deferred or paid in instalments.

As a general principle, where a company makes a purchase of its own shares, any amount paid for the purchase in excess of the amount of capital originally subscribed for the shares is taxed in the hands of a recipient who is an individual as an income distribution by the company. However, relief from UK tax on income on the distribution element is available in certain circumstances where a company purchases its own shares. If this relief applies, the share purchase is treated as a capital transaction for the shareholder, which will be more efficient in some circumstances (e.g. entrepreneurs relief may reduce the effective rate of tax down to 10%). It is important that you take specialist accountancy advice as to the tax treatment of any buyback and whether it will be necessary to apply to HMRC for clearance.

Share buyback contract

A company may only make an off-market purchase of its own shares pursuant to a contract approved by the shareholders before the purchase or, where the purchase is for the purposes of or pursuant to an employees' share scheme, under a general authority given by the shareholders. Additional approvals and notices are required where the share buyback is to be financed out of capital.

A buyback contract is an agreement between the company and one or more shareholders whose shares are to be repurchased. It can be a simple agreement providing for the company to purchase the relevant shares or, alternatively, it could be a contract under which the company may become entitled or obliged to purchase the shares in the future, subject to certain conditions. In certain circumstances it may also be advisable to include further terms in the contract, such as restrictive covenants on outgoing shareholders and confidentiality provisions.

The contract should set out the main terms of the buyback and a copy of the buyback contract must be made available to the shareholders of the company for inspection, both before and after its approval.

Post buyback

Shares bought back by a private company as part of an off-market purchase:

- May be cancelled or held in treasury, if purchased out of distributable profits or from cash; or
- Must be cancelled, if purchased from the proceeds of a new issue of shares or from capital.

Where the shares are cancelled, the cancellation takes place immediately upon the return of the shares to the company and the company's issued share capital is reduced by an amount equal to the nominal value of the shares bought back.

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Various forms are required to be filed at Companies House and HMRC when conducting a buyback. In almost all buybacks, stamp duty is payable on the purchase price of the shares at a rate of 0.5%, unless the repurchase price is £1,000 or less.

The company registers must be updated to reflect the cancellation of shares following the buyback or any shares held in treasury by the company.

A copy of the buyback contract must be kept available for inspection by shareholders, free of charge, at the company's registered office for a period of at least ten years beginning with the date that the purchase of all shares under the contract is completed or the date that the contract otherwise determines.

If you would like to know more about this topic or our legal services, please contact Mark Williams on 01323 435955 or mew@gabyhardwicke.co.uk

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