

**Sourcing your Shares:  
The Share Sourcing  
Conundrum**

William Franklin and Anna Wordworth  
Pinsent Masons

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**Overview**  
Issue or buy decision  
AND  
Treasury or Trust decision

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**Overview**  
Issue or buy decision  
AND  
Treasury or Trust decision

**Practical Application**  
Example in the UK

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**Financial considerations**

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1. Issue ← [Insufficient short term cash] Buy

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**Financial considerations**

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1. Issue ← [Insufficient short term cash] Buy

2. Issue [Is it a good time to buy shares? Is the share price low? How many?] → Buy

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**Financial considerations**

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1. Issue ← [Insufficient short term cash] Buy

2. Issue [Is it a good time to buy shares? Is the share price low? How many?] → Buy

3. Issue ← [Dilution • temptation of printing presses] Buy

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### Financial considerations

1. Issue	←	Insufficient short term cash	→	Buy
2. Issue		Is it a good time to buy shares? Is the share price low? How many?	→	Buy
3. Issue	←	Dilution • temptation of printing presses		Buy
4. Issue		Dilution Constraints UK's 10% ABI Limit	→	Buy (if Trust)

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### Financial considerations

1. Issue	←	Insufficient short term cash	→	Buy
2. Issue		Is it a good time to buy shares? Is the share price low? How many?	→	Buy
3. Issue	←	Dilution • temptation of printing presses		Buy
4. Issue		Dilution Constraints UK's 10% ABI Limit	→	Buy (if Trust)
	←	USA's ISS calculated plan limits	→	Buy (Treasury)

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### Dividends on New Shares

New issue saves cost of buying shares  
But: creates commitment to future dividends

Year	0	1	2	3	4	5	etc
A Cash saved by not buying	■						
B Cash outflow for dividends		■	■	■	■	■	■

Is B>A?  
Need to take account of time value of money so discount cash outflow of dividends to present value

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**Financial considerations**

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5. Issue

Dividends  
 • Present value of future cash flows

➔ Buy

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**Dividends on New Shares**

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New issue saves cost of buying shares  
 But: creates commitment to future dividends

Year	0	1	2	3	4	5	etc
A Cash saved by not buying	■						
B Cash outflow for dividends		■	■	■	■	■	■

Is  $B > A$ ?

Need to take account of time value of money so discount cash outflow of dividends to present value

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**Financial considerations**

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5. Issue

Dividends  
 • Present value of future cash flows

➔ Buy
  

6. Issue

Finance cost  
 • Lower long term interest rates

➔ Buy

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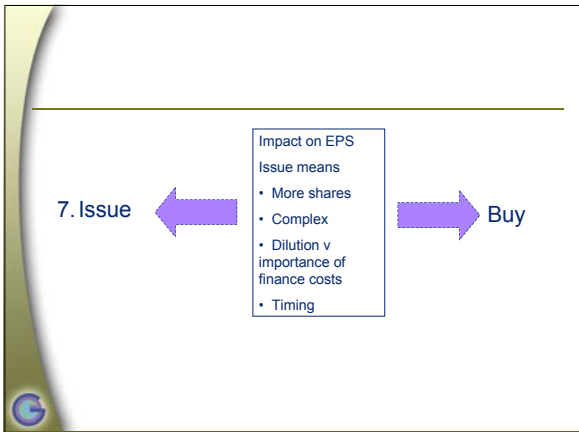
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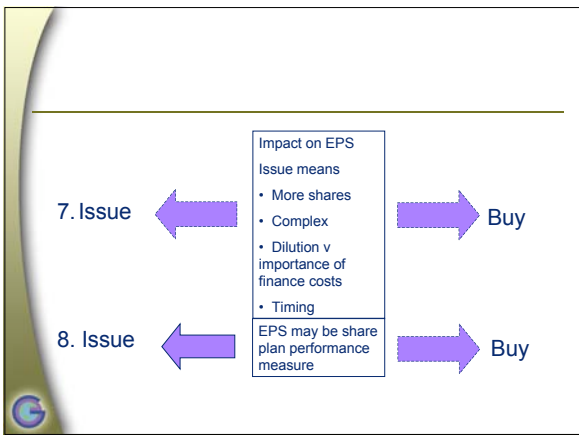
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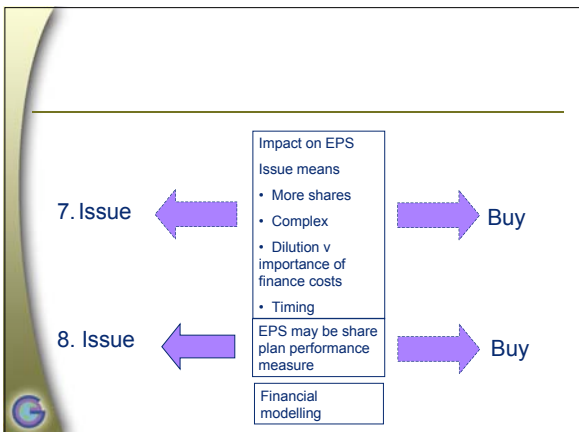
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**Accounting considerations**

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9. Pre Share Based Payment

Issue ← Sourcing could matter for Profit and Loss expenses Buy

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**Accounting considerations**

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9. Pre Share Based Payment

Issue ← Sourcing could matter for Profit and Loss expenses Buy

Post Share Based Payment

Issue ← Sourcing irrelevant for Profit and Loss expenses → Buy

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**Taxation**

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- Tax can be an obstacle to use of Trusts in some jurisdictions
- In UK

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**Taxation**

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- Tax can be an obstacle to use of Trusts in some jurisdictions
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  - Transfer pricing



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**Taxation**

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- Tax can be an obstacle to use of Trusts in some jurisdictions
- In UK
  - Transfer pricing
    - UK Tax authority busy



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**Taxation**

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- Tax can be an obstacle to use of Trusts in some jurisdictions
- In UK
  - Transfer pricing
    - UK Tax authority busy
      - Waterloo



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**Taxation**

- Tax can be an obstacle to use of Trusts in some jurisdictions
- In UK
  - Transfer pricing
  - UK Tax authority busy
  - Waterloo
  - Recent draft Guidance

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**Taxation**

- Tax can be an obstacle to use of Trusts in some jurisdictions
- In UK
  - Transfer pricing
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Close Companies

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**Taxation**

- Tax can be an obstacle to use of Trusts in some jurisdictions
- In UK
  - Transfer pricing
  - UK Tax authority busy
  - Waterloo
  - Recent draft Guidance

Close Companies

Loan to Trust

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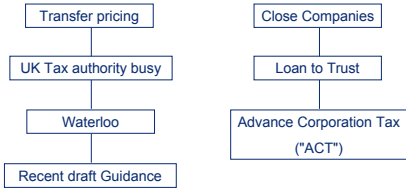
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## Taxation

- Tax can be an obstacle to use of Trusts in some jurisdictions
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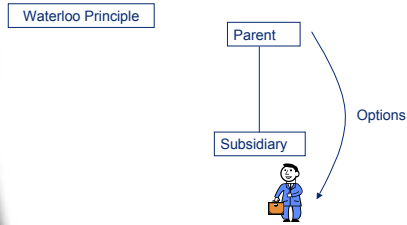
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## UK Transfer Pricing



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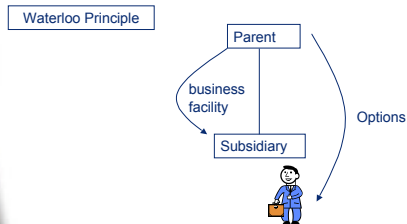
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## UK Transfer Pricing



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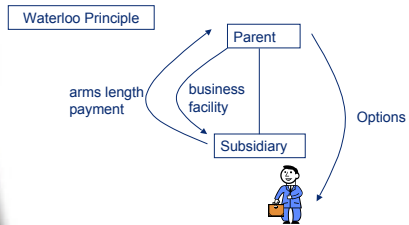
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## UK Transfer Pricing



But is arms length payment Revenue or Capital for Parent?  
If it is a Capital receipt for Parent then it is not subject to corporation tax in UK.



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## UK Revenue

2004 and prior

Issue ← Capital status of payment to parent Buy



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## UK Revenue

2004 and prior

Issue ← Capital status of payment to parent Buy

2005 onwards (Draft)

Issue ← Reserves "Capital" Buy



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### UK Revenue

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2004 and prior

Issue ← Capital status of payment to parent Buy

2005 onwards (Draft)

Issue ← Reserves "Capital" → Buy

Will other jurisdictions follow UK Revenue approach? (UK Revenue believe it is consistent with existing OECD guidance)

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### UK distributable reserves

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- UK Company Law concept
- Similar to accumulated profit in accounts (but different "Realised" concept)
- Need distributable reserves to
  - pay dividends
  - oil wheels of various corporate transactions

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### Distributable reserves

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Issue (directly) ← Shares held in a Trust or in Treasury reduce distributable reserves Buy

Change: Until UITF38 and Tech64/04 shares in Trust did **not** reduce distributable reserves

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**Why do we use Trusts in the UK?**

- Treasury used to be illegal (still is for private companies)
- Familiar with Trusts
- Independence of trustees
  - close period
  - ring fence shares for employees
- Pure nil cost awards (market value below nominal value)

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**Why do we use Trusts in the UK?**

But

- Costs
- Risk of assets trapped in trust
- Financial Assistance Issues

But key factor

- Shares in Trust do not count for 10% ABI limit while shares in Treasury do
- To change?

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**Changing scene: buy or issue decision**

<b>NOW</b>	<b>BEFORE</b>
Short term cash	Favour issue
Long term cash	Moving to favour buying

Dilution

- More complex not just impact of Limits
- Depends on dividend policy and significance of Financial Measures such as an EPS
- Modelling outcomes

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**Changing scene: buy or issue decision**

	NOW	BEFORE
Accounting	Neutral	Favour issue
Taxation (UK)	Neutral	Favour issue
Distributable reserves (UK)	Favour issue	Neutral

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- Share sourcing: the problems in practice**
- Facts
- FTSE listed UK plc
  - Consolidated accounts under IAS, but domestic accounts under UK standards
  - Number of years of strong growth, then profits warnings - substantial drop in share price
  - Share price below nominal value
  - New CEO – how to attract/motivate
  - Company has small amount of distributable reserves & some cash in business

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- Issues to address**
- Decision to make nil-cost award – large number of shares
  - Need to use trust because nil-cost award
  - How to source shares for trust?
  - Two options:-
    - Issue shares to trust
    - trust buys shares in market

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**Best laid plans**

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- Financial case clear cut – best to fund trust to buy shares in market
- Company has cash to fund trust & shares are cheap
- Would avoid substantial dilution (5% Trust limit ok)
- BUT – UK company law could derail best laid plans



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**Company/market considerations**

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- Good use of company cash?
- Long-term dilutionary impact of new issue
- Interaction with financial assistance/distributable reserves



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**Nil-cost award**

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- UK company unable to issue shares directly to CEO for less than nominal value
- Need to fund trust so trust can make nil-cost award
- Trust law
- UITF 38
- Financial assistance



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### UITF 38

- UK accounting rules for employees' trusts
- Trust normally treated as in essence a division of parent
- Internal transactions (eg loan to trust) ignored
- Shares in trust treated as deduction from shareholders' funds
- Tech 64/04 – deduction reduces distributable reserves for UK plcs (s264 CA)
- Problem: shares in trust will reduce distributable reserves



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### Financial assistance

- Loan to trust (to buy on the market or issue new shares) is financial assistance
- Share schemes exemption
- Additional tests for listed companies:-
  - Does loan reduce net assets?
  - If loan reduces net assets, is that reduction covered by distributable reserves?
- Net assets – Tech 64/04



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### Tech 64/04 (1)

- No requirement to prepare accounting books and records in accordance with UK accounting standards
- If do not – ignore UITF 38
- Trust = separate entity
- Loan = asset of company – is it recoverable?
- Not in this case – nil-cost options
- Loan must be shown as bad debt - reduces net assets



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**TECH 64/04 (2)**

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- TECH 64/04 intended to be helpful
- If rely on Tech 64/04, don't apply UITF 38 & avoid reduction in net assets
- BUT - doesn't help where few distributable reserves and granting nil- cost awards



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**Outcome (1)**

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- Distributable reserves:-
  - insufficient to cover reduction in net assets for new issue shares
  - (just) sufficient to cover reduction for market purchase (loan smaller)
- Company was permitted by company law to use market purchase shares
- BUT – nervous about accuracy of distributable reserves figures
- Also – market perception of use of company's cash



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**Outcome (2)**

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- So:-
  - granted award with additional performance target –sufficient distributable reserves to buy shares when award vests
  - postpone decision to fund trust
- Missed opportunity to buy shares when value low
- US company in same position wouldn't have had same problems



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**Questions?**

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Thank you for your participation



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