The share buyback: Technicalities

Share buybacks are often used as an alternative to the traditional buy and sell structure (where the shareholders purchase each other's shares upon the death or disability of one of them). Even though there are various reasons why the share buyback is implemented instead of the traditional structure, one has to be cognisant of all the legislative and administrative constraints associated with this election. It is not always the most cost effective, tax efficient structure and the Companies Act's requirements can render the transaction unenforceable.

This document is not intended to build a case for or against share buybacks, but aims to give the reader all the necessary information to make an informed decision when faced with this choice.

General

A share buyback is where the company (can also be a close corporation) buys back its own shares. The company enters into an agreement with its shareholder to buy the shares back should that shareholder (or the shareholder's insured representative) die, become disabled or retire.

(Note – where a shareholder is not a natural person, the shareholder will appoint a natural person as representative life insured in respect of any life insurance policies taken out. This natural person is generally the person that is involved in the business. Any reference in this document to a shareholder can therefore be interpreted to include this representative natural person.)

Where the company buys the shares from the shareholder, the company does not become the owner of the shares (a company cannot be a shareholder of its own shares). The number of issued shares will be reduced by the number of shares the company purchased.

Example: When ABC (Pty) Ltd was set up, 1 000 shares were authorised at a value of R1 a share. The total shares were issued to Peter and Paul, the only shareholders of the company – each hold 500 shares. Therefore the base cost at which they acquired the shares is R500. The value of the business is R1 000 000. Upon the death of Peter the company buys his 500 shares for R500 000 utilising funds from an insurance policy taken out specifically for this purpose. Once the transaction is concluded, the company cancels 500 of the issued shares, leaving only 500 shares in issue – the authorised shares remain at 1 000. Paul will now be the sole shareholder of the company as he holds 100% of the issued shares and the value of his shareholding increases to R1 000 000.

Important note

- The above example illustrates the impact the share buyback has on the share structure of the business, however, it also illustrates that the value of the remaining shareholder's shares being increased automatically.
- The relevance of this is that the remaining shareholder's base cost of his 500 shares remain at R500 but the market value has now increased from R500 000 to R1 000 000 due to the share buyback. This increases the potential capital gains tax liability of this remaining shareholder should the shares be sold any time after the share buyback transaction.

The Companies Act, No. 71 of 2008

In terms of this Act (similar provisions are contained in the Close Corporation Act), a company can repurchase its own shares, but only if all the requirements of the Act are fulfilled. The requirements are as follows.

Section 46: Board resolutions

This section requires a board resolution to be passed to authorise the repurchase of the shares. Furthermore, the board has to adopt a special resolution to acknowledge that it did apply the solvency and liquidity test and that they reasonably concluded that the company will satisfy both tests immediately after the buyback transaction.

In terms of Section 46(3) of the Act, the buyback transaction must be completed within 120 business days after the conclusion of the board resolution. If this is not achieved, the board must reconsider the solvency and liquidity test at the time of the actual transaction.

Important note

- It is generally impossible to fulfil the transaction within 120 business days after the conclusion of the board resolution as the transaction is subject to the death or disability of a shareholder. This fact must be acknowledged in the resolution and it should outline the process that will be followed once the event takes place.
- Upon the death or disability of a shareholder the board will once again have to pass the board resolutions as per the requirements. It is advised that the board members appoint an alternate director to replace the deceased, disabled director or shareholder to ensure that the administrative requirements are fulfilled (that is, the decision-making requirements as provided for in the Act).
- In terms of the Companies Act the following votes are required for a resolution and a special resolution to be effective:
  - Resolution: Simple majority unless the Memorandum of Incorporation determines otherwise
  - Special resolution: 75% of the voting rights.

Section 4(1): Solvency and liquidity tests defined

This section defines the liquidity and solvency tests. In essence it determines that a company will satisfy the solvency and liquidity tests at any particular time, if:

- The assets of the company is equal to or exceeds the liabilities of the company, and
- It appears that the company will be able to pay its debts as they become due in the ordinary course of business for a period of 12 months after the date on which the test is considered or the repurchase transaction was concluded.

Important note

- The fact that a life policy is used to fund the share buyback transaction will not necessarily guarantee that the tests will be met after the death or disability of a shareholder.
- As shown, the requirement relating to the liquidity test applies at the time of the transaction, immediately thereafter and for a period of 12 months after the transaction. Therefore, if a company is illiquid to the extent that it cannot pay its debts as it becomes due and payable prior to the death or disability of the shareholder, and the policy then pays out to the company after the shareholder's death or disability, it is likely that the company will remain insolvent after the payment of the purchase price (in terms of the buy-and-sell agreement) insofar the purchase price is equal to the policy proceeds (net of estate duty).

Section 48: Restrictions

Section 48(3) determines that the company cannot buy its own shares if the result of that acquisition is that there are no longer any shares in issue.

Important note

- A share buyback cannot be implemented where the possibility exists that all the shareholders shares are purchased at any given time as this will result in no shareholders and no shares being in issue. It is a legal requirement for a company or close corporation to have at least one shareholder or member at all times.
- Therefore, where there are only two or three shareholders and there is a possibility of simultaneous death of all the shareholders, it is important to consider the traditional buy-and-sell arrangement, if not for all the shareholders, then at least for one of them.

Section 48(6) determines that if the company buys its own shares back without fulfilling the requirements of Section 46 (resolutions and the solvency and liquidity tests), the company can apply to a court to reverse the acquisition within a period of two years. The court may then order for the shareholder from whom the shares were repurchased, to pay back the purchase price to the company and for the company to issue the equivalent number of shares back to that shareholder, estate or beneficiary.

Furthermore, this section determines that if a director was present at the meeting where the board resolution was concluded and that director failed to vote against the transaction knowing that the solvency and liquidity tests were not being met, then that director (or directors) can be held personally liable for any losses suffered by the company as a result of the transaction.

Important note

- The fact that the company can apply to the court to nullify the transaction for a period of two years after the conclusion of the transaction is an element that must be discussed with the client – especially in circumstances where the company's solvency and liquidity is questionable or volatile.
- It is also very important for the directors of the company to understand the implication if they are part of a decision to conclude the transaction knowing that the liquidity and/or solvency tests are not met. This will result in personal liability and can impact their personal financial situation severely.

From an administrative point of view, Section 48 distinguishes between the processes where less than 5% of the shares are being sold and where more than 5% are sold. If less than 5% of the shares are subject to a share buyback, the following is required:

- The board must pass a resolution to give effect to the decision to repurchase its shares. If directors are involved in the transaction, then a special board resolution is required.
- The board must also pass a special board resolution that the solvency and liquidity tests are met.

If more than 5% of the shares are being repurchased:

- The board must pass a special board resolution to give effect to the transaction,
- The board must also pass a special resolution that the solvency and liquidity tests are met,
- The board must acquire a prescribed report from an independent expert as prescribed in Section 114 and 115 of the Act (report on the financial position of the company). It is worthwhile to mention that this report can be quite expensive to obtain.

Funding a share buyback transaction

As with a traditional buy-and-sell agreement, the share buyback transaction can be funded by taking out life insurance policies. In this case, the company will be the policyholder (and therefore entitled to the proceeds) and the shareholder will be the life insured.

Income tax implications

The premiums payable on the policy are not tax deductible as the requirements of Section 11(w)(ii) will not be met.

Paragraph (m) of the gross income definition determines the following:

> "any amount received or accrued in respect of a policy of insurance of which the taxpayer is the policyholder, where the policy relates to the death, disablement or severe illness of an employee or director (or former employee or director) of the taxpayer, including by way of any loan or advance: Provided that any amount so received or accrued shall be reduced by the amount of any such loan or advance which is or has been included in the taxpayer's gross income;"

Therefore, the proceeds received from the policy on the life of the shareholder must be included in gross income of the company if that shareholder is also an employee/director (which is generally the case).

Section 10(1)(gH) provides for an exemption where the amount paid from the policy was due to the death, disablement or severe illness of the employee or director (or former employee or director) of the policyholder and no premiums paid by the policyholder on that policy was tax deductible on or after 1 March 2012.

As the premiums are not tax deductible, the proceeds will be tax free in the hands of the company.

(Note – the policy proceeds will also be exempt from capital gains tax due to the exclusion contained in paragraph 55(e) of the Eight Schedule to the Income Tax act. This exclusion applies to all pure risk policies.)

Estate duty implications

The policy proceeds will be a deemed assets in the estate of the deceased shareholder and may be subject to estate duty since the requirements set in Section 3(3)(a)(iA) are not met – the policyholder (the company) and the deceased life insured are not co-shareholders in relation to each other. If one was to rely on section 3(3)(a) the exemption will also not apply as it cannot be argued that the policy was not taken out at the instance of the deceased. Therefore, it is prudent to make provisions for estate duty by increasing the sum insured.

Important note

- Where a policy is a deemed asset in the estate of the life insured and estate duty can be attributed to that policy's proceeds, the executor is entitled to claim the proportionate estate duty from the recipient of the policy proceeds. If the company wants to ensure that it has a sufficient net amount to fund the agreed purchase price, it will have to increase the sum insured to provide for the estate duty.
- To calculate the gross sum insured required one will use the following formula:
  - To provide for estate duty at 20%, the sum insured must be divided by 0.8;
  - To provide for estate duty at 25%, the sum insured must be divided by 0.75.

The purchase price

Subject to dividends withholding tax (DWT)?

In terms of the definition of a 'dividend' as contained in the Income Tax Act, a distribution made by a company for the repurchase of its own shares will be seen as a 'dividend' (subject to exceptions).

In this case, the purchase price paid to acquire the shares will be subject to DWT – which will be 20% of the dividend declared to the shareholder (unless one of the exemptions from DWT applies).

As the purchase price is a deemed dividend, the amount has a revenue nature and is not a capital. Hence, no capital gains tax will be payable by the seller.

Subject to capital gains tax (CGT)?

There is an exception to the above dividend rule – where the purchase price is seen as a reduction or return of Contributed Tax Capital (CTC).

This essentially means that the company is returning capital to its shareholder and it is potentially subject to CGT insofar it exceeds the base cost of the shares. Silke on SA Income Tax explains CTC as follows:

> "…CTC is a notional amount. It represents, in common parlance, the consideration received by the company for the issue of its shares, namely, the stated capital or share capital and share premium. It follows that a company's CTC will increase when shares are issued and will decrease when a portion of the CTC is transferred or returned to a shareholder …"

CTC is calculated as follows:

- Share capital and share premium of company immediately before 1 January 2011,
  Less (–)
- Any amount available for distribution as a dividend prior to 1 January 2011,
  Plus (+)

- Any consideration received or accrued to the company for the issue of shares on or after 1 January 2011.

The auditor will have to determine the CTC as at 1 January 2011 and then again when the buyback transaction takes place. The directors will then have to resolve whether a portion of the purchase price is a return of CTC. The portion of the purchase price that is not a return of CTC will then be a deemed dividend and subject to DWT.

Important note

- In many instances, small- and medium-sized businesses' CTC consist of shares at par value with no share premium. For example, there were 1 000 shares authorised and issued at the inception of the company at R1 per share par value. In this instance, the maximum CTC will be R1 000 (unless they issued additional shares after 1 January 2011).
- Therefore, in most cases, the purchase price will be treated as a deemed dividend and therefore subject to DWT.
- Thus, it is prudent to make provision of the DWT that the company will have to withhold from the purchase price. This can be achieved by applying the following formula:

$$\text{Net purchase price required} / \ 0.80\ (100\% - 20\%)$$

- If provision is made for DWT and estate duty the calculation will be as follows:
  - Step 1: Net purchase price required / 0.80 (DWT provision)
  - Step 2: Amount determined above / 0.80 (or 0.75) (Estate duty provision)

Obligation in terms of the Tax Administration Act

Section 34 of this Act deal with reportable arrangements and was amended in 2015 to include share buybacks. Where a company buys its own shares back for a value of more than R10m and where that company issues or has to issue shares in the 12 months after the share buyback transaction, it has to be reported to SARS.
The Act provides for exceptions to this rule and also prescribes what should be reported on, however, for the purposes of this guide, it is important to note there is a possible obligation on the participants to report and therefore clients must involve their tax practitioners in the transaction from the start.

Conclusion

It is clear that the share buyback is a more complex and onerous alternative when considering business continuity and definitely comes with risks attached. It is important to highlight the requirements and risks to the client and to ensure that they have a clear understanding of both alternatives before making the final decision on the most appropriate for their circumstances.

In addition, Treasury has indicated in the 2017 Budget that share buyback transactions will be under the spotlight and might see anti-avoidance measures being put in place to prevent tax avoidance that can be achieved by using this structure. No further detail is available at this time.

Due to the technical nature of share buybacks, the services of the client's attorney, accountant and tax practitioner should be sought to ensure the proper and effective structuring thereof.