WERKSMANS
ATTORNEYS

TAX

The Tax Implications of eliminating Treasury Shares

4 March 2020 *6 min read*

By Ryan Killoran, Director

It is fairly common for a subsidiary company to hold shares in its holding company, colloquially referred to as treasury shares. Subsidiary companies of an issuer may hold treasury shares for the purposes of facilitating the implementation of employee share schemes. Other reasons why a subsidiary may seek to acquire shares in the holding company include utilising the shares as payment in a business transaction, to structure a Black Economic Empowerment transaction or to utilise the investment opportunity when the share price is trading below net asset value.

Conversely, a holding company may seek to repurchase or acquire the treasury shares held by the subsidiary where the business purposes identified as motivations to hold the treasury shares in the subsidiary are no longer applicable or where the 10% limit as per the Companies Act (on treasury shares held by subsidiaries) has been reached.

Unwinding a treasury shareholding can be achieved by way of a repurchase by the holding company or by way of an *in specie* distribution of the treasury shares by the subsidiary to its holding company. The tax implications of either option is likely to influence the manner of unwinding the treasury shareholding.

In terms of the latter option, a distribution by a subsidiary of an asset to its holding company is a disposal of an asset which is deemed to take place at market value for CGT purposes. If the market value of the treasury shares is greater than the base cost, a capital gain will arise for the subsidiary. The holding company will also have acquired an asset, i.e. the shares in itself, at a market value and will immediately have disposed of that asset by virtue of its cancellation. A cancellation of shares, however, is deemed not to be a disposal for CGT purposes and thus has no CGT consequences.

Eliminating treasury shares in a tax efficient manner could previously be achieved by way of a share repurchase, which if implemented as a dividend, would have had no adverse tax implications for the subsidiary which is disposing of the treasury shares. However, with the introduction and subsequent modification of various anti-avoidance rules dealing with share repurchases and so-called dividend stripping transactions, such a repurchase could give rise to CGT implications for the subsidiary disposing of the treasury shares.

In the context of the above, it is worth noting the contents of SARS Binding Private Ruling 336 (BPR) issued on 6 December 2019 which confirmed the application of the roll-over provisions of the Income Tax Act (“Act”) where the subsidiary holding the treasury shares is liquidated in terms of section 47 of the Act.

Section 47 forms part of so-called corporate roll-over provisions. The special rules are meant to facilitate genuine corporate restructuring and mergers and acquisitions and to promote tax efficiency in the implementation of such transactions by permitting tax 'rollovers' to operate, where the statutory requirements are satisfied.

In the ordinary course, the liquidation, winding-up or deregistration of a subsidiary company will involve the transfer of assets to its holding company which invariably results in adverse tax implications as the transfer may give rise to a liability for normal tax, dividends tax and CGT.

The objective of section 47 is to provide a type of 'roll-over relief' when a liquidating company distributes all its assets to its holding company in terms of a liquidation distribution. To the point, where section 47 applies, a capital gain on the transferred capital assets is deferred in that the base cost of a capital asset is 'rolled over' to the holding company. This roll-over relief applies where the capital asset distributed by the subsidiary is acquired by the holding company.

In the BPR under consideration, Company A was a listed company that held 100% of Company B. Company B held treasury shares in Company A which were acquired by way of a loan advanced from Company A. Company B was to make a liquidation distribution to Company A by way of Company B passing a resolution to distribute its assets, the treasury shares, as a dividend *in specie* to Company A, in anticipation of the deregistration of Company B.

The ruling given by SARS states that the distribution of shares by Company B to Company A constitutes a "liquidation distribution" as defined in paragraph (a) of the definition in section 47(1) with the result that no CGT consequences will result for Company A and Company B from the transfer of the treasury shares.

An important consideration here is that the holding company has to acquire the assets in question (in this case the treasury shares) as a capital asset, where the subsidiary company holds it as a capital asset. This is an essential requirement before the relevant CGT relief can apply. The crucial question that arises in this regard is whether there is an acquisition of an asset by the issuer of shares (Company A) when it receives its own shares pursuant to a distribution from its subsidiary company in the same group. Without elaborating on the technical analysis of this issue, there are diverging views whether the holding company does acquire the treasury shares, but the ruling seems to confirm this view. The view in favour holds that the shares were acquired, and the fact that the treasury shares are immediately cancelled does not alter the fact that the holding company acquired such capital asset. Put differently, there is no requirement that the holding company must acquire and hold such capital asset for the relief in section 47 to apply. The contrary view is that the acquisition and cancellation were simultaneous, so that no asset was acquired.

Accordingly, where the facts allow, the relief afforded in terms of section 47 could be used to eliminate a treasury shareholding on a tax efficient basis. However, owing to these divergent views, given that taxpayers other than the applicant, cannot rely on the BPR in any dispute with SARS, and given that SARS could change their minds about the interpretation despite what it said in the BPR (as has happened in the past), we would recommend that any company wishing to take this route should obtain its own binding ruling.



Ryan Killoran

Director

View Profile