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Share buy-back v Buy-and-sell agreement – which makes more sense?

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Contents

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Background

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- For many years customary to arrange the transfer of business interests from deceased shareholder to survivors by way of buy-and-sell agreement
- Has come under attack lately: view that it is a *pactum successorium* – do not agree
- Share buy-back by the company perceived as an "easy" solution
- Proponents of this view have possibly not thought through all the implications

Buy-and-sell structure

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Anet owns 50%, Brian 30% and Charles 20% shares in ABC (Pty) Ltd. They enter into an agreement which provides that in case of any of them dying, the other two will buy the deceased's shares at market value as at date of death in the proportions that the survivors' shares stand to each other.

Therefore, if Anet dies, Brian will buy 30/50 (30+20) x 50 = 30% of Anet's shares and Charles will buy 20/50 x 50 = 20% of Anet's share from her executor. After these sales, Brian will then hold 60% and Charels 40% of the company shares.

Section 3(3)(a)(iA) of the EDA

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- If the agreement is funded by life insurance on the lives of each shareholder, the possibility of double estate duty exists:
  - On the value of the shareholding in the deceased estate; and
  - On the value of the policy as deemed property under sec 3(3)(a)
- To prevent this, sec 3(3)(a)(iA) exempts the policy, provided the requirements are met:
  - The policyholder must have been a co-shareholder of the deceased insured life on date of death;
  - The policy must have been taken out to fund the purchase of the shares (and loan account)
  - The insured life must never have paid a premium on the policy

Life insurance to fund agreement

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- If we assume the market value of all the shares in the company to be R10m, then:
  - Anet and Charles will take out life cover of R3m on Brian's life and Anet will pay 50/70 of the premium and be entitled to 50/70 of the death claim value, while Charles will pay 20/70 of the premium and be entitled to 20/70 of the death claim value
  - Anet and Brian will take out life cover of R2m on Charles's life and Anet will pay 50/80 of the premium and be entitled to 50/80 of the death claim value, while Brian will pay 30/80 of the premium and be entitled to 30/80 of the death claim value
  - Brian and Charles will take out life cover of R5m on Anet's life and Brian will pay 30/50 of the premium and be entitled to 30/50 of the death claim value, while Charles will pay 20/50 of the premium and be entitled to 20/50 of the death claim value

In diagram format …

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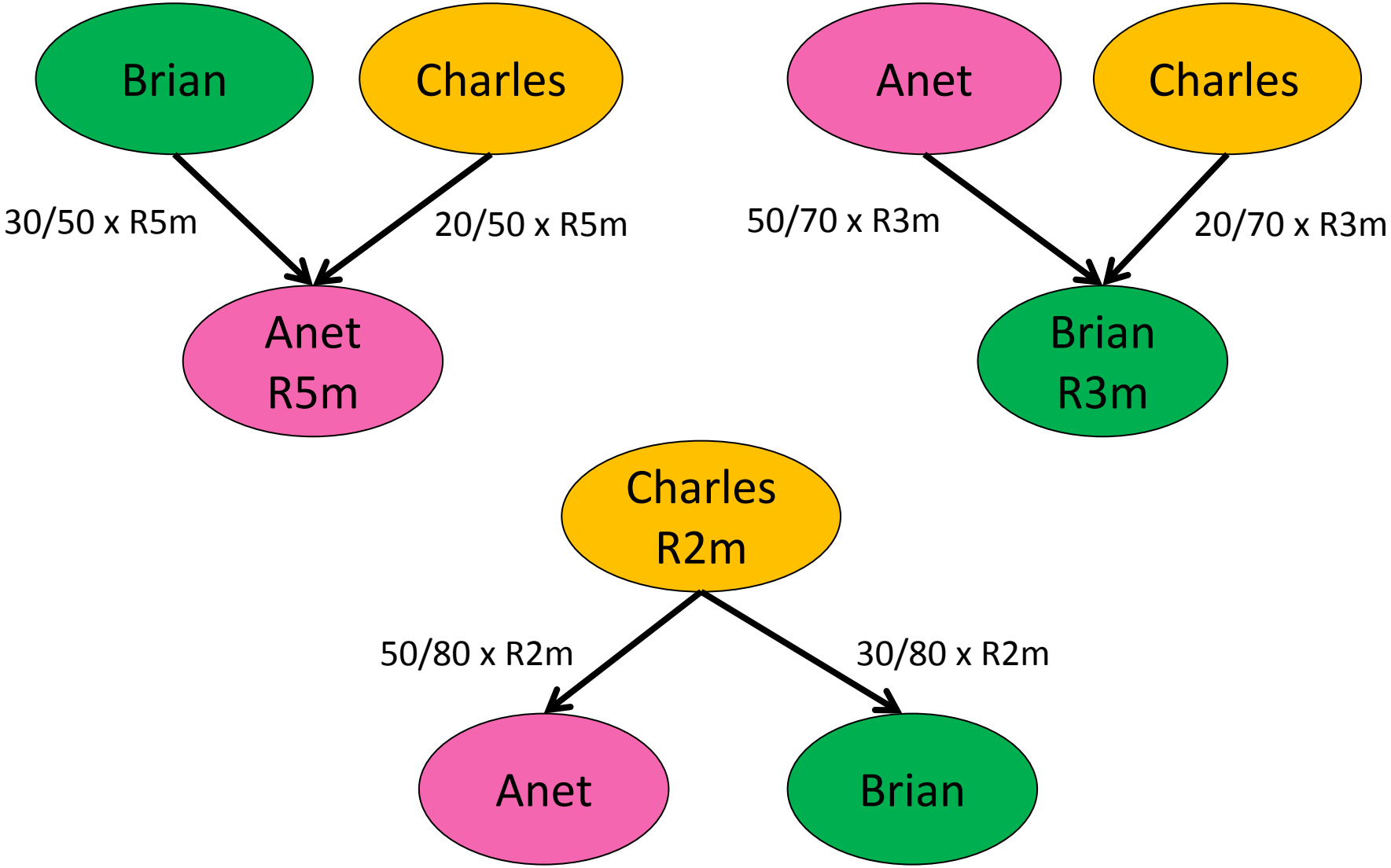

Further points

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- Any loan accounts to the credit of the shareholder can also be taken over by the surviving shareholders
- The policies may include the amounts of these loan accounts and will still comply with sec 3(3)(a)(iA)
- The shareholding can be specifically bequeathed or if not, will form part of the residue
- The executor will be bound to sell in accordance with the buy-and-sell agreement if the agreement was properly structured and signed
- The proceeds of the sale will then be awarded by the executor to the relevant heir or legatee
- The sale of the shares will be a disposal by the deceased estate for CGT purposes

Share buy-back – the mechanics

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- A company may buy back its own shares from the shareholder(s) (Sec 48 of the Companies Act, 71 of 2008)
- Payment by the company for the shares will be a "distribution" as defined in sec 1 of the CA
- The board of the company must pass a resolution authorising the distribution (s 46)
- The company must satisfy the solvency and liquidity test –
  - Assets of company must exceed liabilities
  - Company must be able to pay debts when due for 12 months following the distribution

(S 4)

Share buy-back in ABC (Pty) Ltd

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- Assume Brian dies and board of the company adopts resolution that his 30% shares will be bought back
- Assume that 100 shares were issued and that Brian held 30 of those.
- If company buys back Brian's shares for R3m, the issued shares will be reduced to 70 and the net value of the company will be reduced to R7m, unless the buy-back is funded by a life policy on Brian's life
- If there is a life policy, the value of the remaining shareholding will equal the value of the company before the buy-back

Share buy-back diagram

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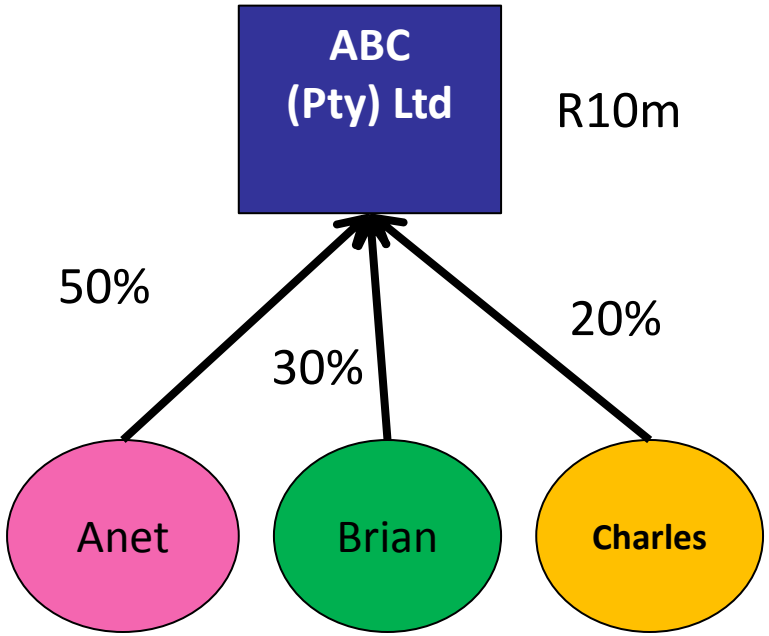

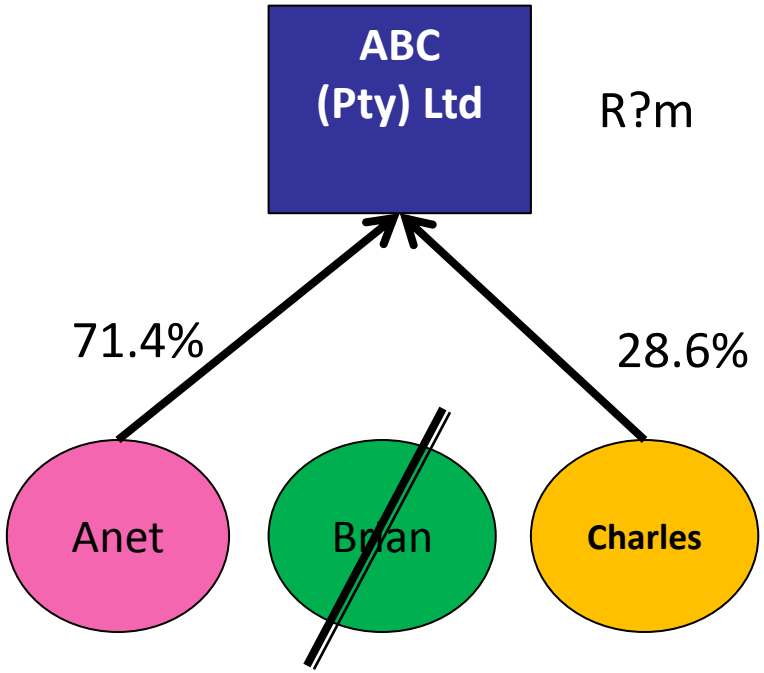

- Value of ABC after share buy-back will depend on whether it was funded by life insurance

Share buy-back in ABC (Pty) Ltd (2)

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- The proportionate shareholding will change – Anet will now own 71.43% of the shares, or 50 shares, and Charles will own 28.57% of the shares, or 20 shares
- The value of their holdings will remain the same at R5m for Anet and R2m for Charles
- There are some tax implications!

Different tax implications

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- The payment to the estate of the deceased for the bought back shares will be regarded as a “distribution” as defined in the CA
- The payment will also be regarded as a dividend for income tax purposes, except to the extent that the payment constitutes “contributed tax capital” (CTC) (s 1 of the Income Tax Act, 58 of 1962
- On our example, if Brian contributed R30 in return for his shares when ABC was floated, R30 of the R3m pay-out in case of his death could represent CTC
- If the board does not take a decision w.r.t. CTC, the whole pay-out will be a dividend and taxed as such

Buy-back funded by life insurance

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- Should the parties in ABC (Pty) Ltd decide to fund the buy-back with life insurance, they will have to provide for:
  - Dividends tax (R3m ÷ 0.85(1-0.15) = R3,529,412)
  - Estate duty (R3,529,412 ÷ 0.8 (1-0.2) = R4,411,765)
- Estate duty will arise because the company will take out the policy and it will not be exempt from being "deemed property" because the requirements of s 3(3)(a)(ii) of the EDA cannot be satisfied
- Executor will have to re-coup the ED from the company under s 11 of the EDA

S 3(3)(a)(ii)

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(3) Property which is deemed to be property of the deceased includes—

(a) so much of any amount due and recoverable under any policy of insurance which is a "domestic policy", upon the life of the deceased as exceeds the aggregate amount of any premiums or consideration proved to the satisfaction of the Commissioner to have been paid by any person who is entitled to the amount due under the policy, together with interest at six per cent per annum calculated upon such premiums or consideration from the date of payment to the date of death: Provided that the foregoing provisions of this paragraph shall not apply in respect of any amount due and recoverable under a policy of insurance, if—

…

(ii) except where the provisions of paragraph (i) or (iA) of this proviso apply, the Commissioner is satisfied and remains satisfied that such policy was not effected by or at the instance of the deceased, that no premium on such policy was paid or borne by the deceased, that no amount due or recoverable under such policy has been or will be paid into the estate of the deceased and that no such amount has been or will be paid to, or utilized for the benefit of, any relative of the deceased or any person who was wholly or partly dependent for his maintenance upon the deceased or any company which was at any time a family company in relation to the deceased;

Other implications

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- When the company buys back the shares and the buy-back is funded by a policy, the value of the shareholding of the survivors will increase
- The base cost of their shares will, however, remain the same because they have not bought additional shares at the date of death value
- Therefore, when the survivors dispose of their shares sometime in future, their capital gains will be higher as a result
- Company will have to retain independent expert (sec 114 and 115 of the CA)

Share buy-back v Buy-and-sell Summary

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Share buy-back	Buy-and-sell
If funded by a policy, ED on policy	If structured correctly, no ED on policy
ED on value of shares in estate	ED on value of shares in estate
Payment to estate is a dividend and subject to dividend tax	Payment to estate tax free
Does not increase share base cost for CGT	Buying shares of deceased increases BC
Number of issued shares decreases	Issued shares stay the same
When company acquires more than 5% of own shares, must retain independent expert who must submit report to Board	Company does not acquire the shares, co-shareholders do
Company must satisfy the solvency and liquidity test for 12 months after the share buy-back	
Board needs to take a resolution to determine whether any part of the payment is regarded as CTC	

M Botha, *Share Buy-back v Shareholder's Buy-and-Sell Agreement*, **Insurance and Tax**, Vol 29 No 3, Sept 2014, LexisNexis.


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