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## **TREATMENT OF SHARE BUY-BACKS AND SHARE CAPITAL REDUCTION FOR INCOME TAX PURPOSES**



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- Insertion of footnotes 1 and 2
- Amendment to paragraphs 5 and 8 to reflect the current company tax rate
- Amendment to paragraphs 5, 8 and 9 to clarify the type of company to which franking requirement is applicable

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## **TREATMENT OF SHARE BUY-BACKS AND SHARE CAPITAL REDUCTION FOR INCOME TAX PURPOSES**

### **INTRODUCTION**

- 1 Prior to 18 Nov 98, section 76(1) of the Companies Act does not allow a company to acquire its own shares. This is to prevent a company from returning capital to shareholders to the detriment of creditors. A company can only return capital to its shareholders by way of a capital reduction under section 73 of the Companies Act and this will require, among other things, confirmation by the Court.
- 2 Following the amendments to the Companies Act, which came into operation on 18 Nov 98, a Singapore incorporated company is now allowed to buy back its own ordinary shares using its distributable profits. The term “distributable profits” as defined in the Companies Act means profits that is available for payment as dividends, but excludes any amount in the share premium account and capital redemption reserve.
- 3 This Practice Note sets out:
  - (i) the income tax treatment for the company which engages in a share buy-back<sup>1</sup> and for the shareholders, in particular whether the amount distributed pursuant to a share buy-back is treated as a payment of dividends which requires the application of section 44 of the Income Tax Act;
  - (ii) the income tax treatment of share capital reduction.

### **ADMINISTRATIVE PRACTICE**

#### **Share buy-backs**

- 4 For income tax purposes, a distribution to shareholders out of a company's distributable profits is a payment of dividends. This is the case even if the distribution is out of gains or profits which is not subjected to tax.
- 5 Since a company can only buy back its own shares using its distributable profits under the amendments in 1998 to the Companies Act, a company which engages in a share buy-back will therefore in every case, be regarded as having paid a dividend to the shareholders from whom the shares are acquired. The company under the imputation system or remain on the imputation system for the

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<sup>1</sup> section 10J of the Income Tax Act.

purposes of paying franked dividend will thus have to provide for franking of the buy-back at the prevailing corporate tax rate (20% from 1 Jan 2004) in the same way as paying a taxed dividend, the amount paid out for the buy-back being the net dividend. Like any other taxed dividend, the company is required to submit to the Comptroller of Income Tax (CIT) a copy of the section 44 statement for the purpose of determining the balance or charge immediately after the share buy-back. Franking is not required if the buy-back is out of income which can be used to pay exempt dividends ("exempt income"). In this case, an amount equals to the amount paid out pursuant to the share buy-back shall be deducted from the account maintained for purposes of paying exempt dividend ("special account").

- 6 The tax treatment of the receipts from the buy-back in the hands of the shareholders will depend on whether the disposal arises from a "market purchase" or "off-market purchase".
- 7 For shareholders who dispose of their shares through "market purchase", the disposal of their shares will be treated like any other disposal which they make on the stock exchange. Thus the proceeds received by these shareholders from a "market purchase" will be treated as proceeds from the disposal of shares and not a dividend. Whether or not the proceeds are taxable in the hands of the shareholders will depend on whether they are receipts of an income or capital nature. This treatment applies notwithstanding that the company is regarded as having made a distribution of a dividend.
- 8 For "off-market purchase"<sup>2</sup> where the share buy-back is made otherwise than on a stock exchange, the amount received by the shareholders will be treated as a receipt of a dividend. Unless the company under the imputation system or remain on the imputation system for the purposes of paying franked dividend has paid the amount out of exempt income so that the dividend is an exempt dividend, the shareholders will be assessed to tax on the amount received grossed up by a factor of 100/80 (this being the gross dividend) and be allowed a credit for the tax deducted at source of 20% of the grossed up amount. This treatment applies even if the shareholder is assessable to tax on profits arising from the disposal of shares. In such a case, the cost of the shares sold by him pursuant to the off-market purchase will be pro-rated to the shares remaining after the off-market purchase e.g. if he had 1000 shares costing \$18 each and sold 100 in the off-market purchase, the cost of the remaining 900 shares will be \$20 per share ( $18 + 18 \times 100/900$ )
- 9 When a company under the imputation system or remain on the imputation system for the purposes of paying franked dividend makes an off-market purchase<sup>2</sup> not out of exempt income, it is required, like any other taxed dividend, to furnish to each shareholder with a certificate setting forth the amount paid to the shareholder and the amount of tax which the company has deducted or is entitled to deduct. The shareholder, unless otherwise stated, will then have to

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<sup>2</sup> made in accordance with an equal access scheme under section 10J of the Income Tax Act.

submit the certificate together with his annual income tax return to the CIT for the dividend to be assessed and the credit to be allowed.

- 10 Two examples showing the tax treatment of “market purchase” and “off-market purchase<sup>2</sup>” are given in Annex 1.

### **Share capital reduction**

- 11 In the case of a share capital reduction, if the reduction is made out of profits that are available for payment of dividends, the payment is treated, for income tax purposes, as a payment of dividends, both to the company making the reduction and to the shareholders. The normal tax rules governing the payment of dividends would apply.
- 12 On the other hand, if the reduction is made out of contributed capital (i.e. share capital and share premium excluding any amount of profits capitalised through bonus issue), the payment to the shareholders will be treated as a return of capital and not a payment of dividends. Consequently, the cost of the investment held by the shareholder will be reduced by the amount of capital returned.
- 13 In the case of a company which had previously engaged in capital reduction exercise(s), the amount of contributed capital available for future capital reduction shall be reduced by any amount returned to shareholders which had been treated as a return of capital in the past exercise(s).
- 14 The examples at Annex 2 give some simple illustrations on how a share capital reduction will be treated for income tax purposes.
- 15 Taxpayers who have any enquiries on this Practice Note may call IRAS for clarification.

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**Example 1 - Off-market purchase**

A company buys back 1,000 of its own shares at \$6 each pursuant to an off-market exercise in the year 1998. The cost to the shareholder for the 1,000 shares is \$5,000.

**Tax treatment for the company**

The company is treated as paying a net dividend of \$6,000 and accordingly its section 44 account will be debited by an amount of \$2,108 ( $\$6,000 \times 26/74$ )

**Tax treatment for the shareholder**

The shareholder will be assessed on the gross dividend of \$8,108 ( $\$6,000/0.74$ ). At the same time, he can claim a credit for the tax deducted at source of \$2,108 ( $\$6,000 \times 26/74$ ). The cost of \$5000 paid by him will be pro-rated to the shares remaining after the off-market purchase.

**Example 2 -market purchase**

A company buys back 1,000 of its own shares at \$6 each from the stock exchange i.e. market purchase in the year 1998. The cost to the shareholder for the 1,000 shares is \$5,000.

**Tax treatment for the company**

As in the case of Example 1 above, the company will be treated as paying a net dividend of \$6,000 and accordingly its section 44 will be debited by an amount of \$2,108 ( $\$6,000 \times 26/74$ )

**Tax treatment for a shareholder who is trading in shares**

The \$6,000 received by the shareholder will be treated as proceeds from the disposal of the 1,000 shares and the gain from disposal of the shares of \$1,000 ( $\$6,000 - \$5,000$ ) will be subjected to tax

**Tax treatment for a shareholder who is not trading in shares**

The \$6,000 received by the shareholder will be treated as proceeds from the disposal of the 1,000 shares, but the gain from disposal of the shares is not taxable.

**Example 3**

**Company makes a capital reduction out of issued share capital which has not been increased through any bonus issues before**

Before capital reduction

Issued share capital (20 million ordinary shares @ \$1 each)	\$20,000,000
Share premium account	<u>\$ 5,000,000</u>
Contributed capital	<u>\$25,000,000</u>

Company decides to make a capital reduction of \$2,000,000 out of issued share capital.

After capital reduction

Issued share capital	<b>\$18,000,000</b>
Share premium account	<u>\$ 5,000,000</u>
Contributed capital	<u>\$23,000,000</u>

**Tax treatment: Amount of \$2,000,000 returned to shareholders is treated as a return of capital**

**Example 4**

**Company makes a capital reduction out of issued share capital which contains partly profits capitalised through bonus issues**

Before capital reduction

Issued share capital	
Normal share issues (15 million ordinary shares @ \$1 each)	\$15,000,000
Bonus share issues (capitalised from profits) (5 million ordinary shares @ \$1 each)	\$ 5,000,000
Share premium account	<u>\$ 5,000,000</u>
	<u>\$25,000,000</u>
Less: Amount of capital from profits capitalised through bonus share issues	<u>\$ 5,000,000</u>
Contributed capital	<u>\$20,000,000</u>

Company decides to make a capital reduction of \$5,000,000 out of:

Contributed share capital	\$1,000,000
Profits capitalised through bonus issue	<u>\$4,000,000</u>
	<u>\$5,000,000</u>
<u>After capital reduction</u>	
Issued share capital	
Normal share issues	
(15 million ordinary shares @ \$1 each)	<b>\$14,000,000</b>
Bonus share issues (capitalised from profits)	
(5 million ordinary shares @ \$1 each)	\$ 1,000,000
Share premium account	<u>\$ 5,000,000</u>
	<u>\$20,000,000</u>
Less: Amount of capital from profits capitalised through bonus share issues	<u>\$ 1,000,000</u>
Contributed capital	<u>\$19,000,000</u>

**Tax treatment: The \$1,000,000 returned to shareholders is treated as a return of capital while and the amount of \$4,000,000 returned is treated as a payment of dividends**