# Securities transfer tax and “earnout” provisions

Often parties to a sale of shares agreement agree to an ‘earnout’ or ‘agterskot’ clause: a provision that part of the price will be paid in future if certain conditions are met. For example, the parties may agree that, while the seller must transfer ownership of all the shares to the purchaser at the time of the sale, the purchaser will pay a part of the purchase price only if the company reaches specified financial targets in future.

The further payment could be a fixed or variable amount. For example, B could buy A’s shares for R100, while B undertakes to pay A an additional R50 if the profit after tax of the company is at least R30 over the following year. Alternatively, B could undertake to increase the price of R100 by a percentage determined with reference to the amount of the profit after tax.

Securities Transfer Tax (STT) is usually levied in respect of a sale of shares transaction. However, where a sale of shares is subject to an ‘earnout’ provision, the issue arises as to how the amount of the STT is calculated, specifically in the context of unlisted companies.

Section 2(1) of the Securities Transfer Tax Act, No 25 of 2007 (STT Act) provides that STT is levied in respect of every transfer of any security issued by local companies at a rate of 0,25% of the taxable amount of the security as determined in terms of the STT Act.

For purposes of the STT Act, the term ‘security’ includes a share in a company and any member’s interest in a close corporation.

The term ‘transfer’ is defined widely in the STT Act and

includes a sale, assignment or cession, or disposal in any other manner of a security.

In terms of s6(1) of the STT Act the taxable amount in respect of every transfer of an unlisted security is, in the case of an ordinary transfer (that is, otherwise than as a result of a cancellation or redemption of the share):

- the amount or market value of the consideration given; or
- where no consideration is given or the consideration given is less than the market value of that security, the market value of that security.

S3(1)(c) of the Securities Transfer Tax Administration Act, No 26 of 2007 (STT Administration Act) states that STT which becomes payable during a month 'in respect of any transfer' of an unlisted security, must be paid to the South African Revenue Service (SARS) within two months from the end of that month, otherwise SARS may impose interest and penalties.

In the case of an earnout transaction, STT could conceivably be imposed the following ways:

1. STT could be imposed at the time of the sale but only on the amount that accrues at that time (R100 in our example above), as this amount is known; and the contingent payment could be disregarded entirely. However, STT is levied 'in respect of a transfer'. Arguably, this could mean that the intention is that STT must not only be levied 'on transfer' of shares but at any time when consideration accrues in respect of the transfer.
2. STT could be levied at the time of the sale on the full consideration, that is, on the sum of the initial consideration (R100 in the example above) and the contingent consideration (R50 in the first alternative in the example above). If it transpires that the

contingent portion of the consideration does not becomes payable, the taxpayer could apply for a refund in terms of s4 of the STT Administration Act. However, this would not be possible in the case where the contingent amount was a variable amount (as is the case in the second alternative in the example above).

3. The person liable for the STT and SARS could adopt a wait-and-see approach. In other words, STT would not be imposed at the time of the sale but would be imposed only at the time when the full consideration is known, that is, when it becomes certain that the contingent amount will be paid, and what the amount is.
4. The person liable for STT could attempt to place a present value on the contingent portion of the consideration, taking into account the probability that it would become payable. The person could then add that amount to the fixed portion of the consideration to determine the taxable amount, and pay STT on the total.

While, in the case of an earnout arrangement, it is not certain at the time of the sale that the earnout amount will become payable and/or what the amount will be, it is certain that the seller does, at the time of the sale, acquire at least a contingent right to receive the earnout amount.

In the case of *WH Lategan v Commissioner for Inland Revenue 2* SATC 16, and in the context of income tax, a taxpayer sold wine for a certain price, part of which was due in the current tax year, and the balance due in the following tax year(s). The court stated that:

*"So far as a debt was concerned which was payable in the future and not in the year of assessment, it might be difficult to hold that the cash amount of the debt had accrued to the taxpayer in the year of assessment. He had not become entitled to a right to claim payment of the debt in the year of assessment but he had acquired a right to claim payment of the debt in future. This right had vested in him, had accrued*

*to him in the year of assessment and it was a valuable right which he could turn into money if he wished to do so"*

The statement of the court quoted above may also be applicable in determining the amount of STT in the case of an earnout arrangement. At the time of the sale, a right to the earnout amount vests in the seller, and it is a valuable right which could be turned into money, even though it is a contingent right.

In this regard, the United Kingdom (UK) Court of Appeal case of *L M Tenancies 1 plc v IRC* [1998] STC 326 is instructive. The case involved the determination of an amount of stamp duty due in respect of a lease. Under the lease, the rent and a premium were determinable in accordance with a formula which was linked to variables that could only be determined in future.

The court held that the words "the amount of value of the consideration [payable] for the sale" in relevant UK legislation (very similar to the words used in the STT Act) "include amounts or value payable in the future and amounts or value payable immediately or in the future whether <u>unconditionally or contingently</u>."

Naturally, it may be difficult to place a value on the right to the contingent earnout amount and it may well be that in many cases the value will be nil. It should also be remembered that the burden of proving the right amount would rest on the person paying the STT.

It is submitted that, in the light of the tenets of taxation that taxes should be certain and should be collected at the time and in the manner that is most appropriate for the taxpayer, it is likely that South African courts would take the same approach as that taken in the *LM Tenancies* case.

In our view, the relevant legislation should be amended to make it clear how STT should be levied in the case of earnout

arrangements. In the meantime, parties to such transactions should consider approaching SARS for a ruling.