Issue No.8
October 2004

tricor

Business, Corporate and Investor Services
商務、企業、投資者服務

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Ways of Reducing the Issued Share Capital of a Hong Kong Private Limited Company

From time to time, companies incorporated in Hong Kong look for methods of reducing their issued share capital to achieve different objectives, such as to close down business operations, leave certain market segments, clean up the company's balance sheet, eliminate inter-company loans and/or balances due by shareholders or buy out interests of a dissentient or uncooperative shareholder.

Addition to alternatives available to Hong Kong private limited company

There are alternative solutions available to such business exit or corporate restructuring. By virtue of the Hong Kong Companies (Amendment) Ordinance 2003 which came into effect on 13 February 2004, a new subsection has been added to Section 58 of the Hong Kong Companies Ordinance (the "Ordinance") which provides an additional way to reduce a limited company's issued share capital. This will be further explained in section 3 of this article.

Available ways of reducing the issued share capital of a Hong Kong private limited company

In this publication, we will focus on the features and applications of the alternative approaches of reducing issued capital available to a **Hong Kong private limited company**. The term "company" used in this article refers to such type of company only.

Under the Ordinance, there are the following three ways to reduce a company's issued share capital:-

- Purchase of own shares (further explained in section 1 of this article)
- Reduction of share capital with application for a court order (further explained in section 2 of this article)
- Reduction of share capital without application for a court order (further explained in section 3 of this article)

Each of the above ways has its unique prerequisites or achievables and limitations. It is necessary to seek combined and timely input from your accountant, company secretary, auditor, lawyer and/or professional advisor before reaching a decision to proceed. We highlight some of the key characteristics of the alternatives and give illustrative examples in this publication.

1. PURCHASE OF OWN SHARES (SECTIONS 49 TO 49S OF THE ORDINANCE)

Since 1991, the Ordinance has allowed a company to reduce its issued share capital other than by way of an application for a court order. Pursuant to Sections 49 to 49S of the Ordinance, a company may reduce its issued share capital by purchase of its own shares provided that specified conditions are fulfilled.

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Financing for purchase of own shares

Under the Ordinance, shares may be repurchased by a company out of:-

(a) distributable profits;
(b) proceeds of a fresh issue of shares made for the purpose of the purchase; or
(c) capital.

Key accounting concepts

You should note two key accounting concepts for this alternative.

Shares purchased by a company shall be treated as cancelled on purchase, and the amount of the company's issued capital, but not the authorised capital, shall be diminished by the nominal value of those shares accordingly. Where shares are purchased wholly out of the company's distributable profits, the amount by which the company's issued share capital is diminished on cancellation of the shares purchased by the company shall be transferred to a reserve, called the **"capital redemption reserve"** which is of a non-distributable nature. If the shares are purchased wholly or partly out of the proceeds of a fresh issue and the aggregate amount of those proceeds is less than the aggregate nominal value of the shares purchased, the amount of the difference shall be transferred to the capital redemption reserve.

The payment which may be made out of capital (being the **"permissible capital payment"**) is such an amount as, taken together with (i) any available profits of the company; and (ii) the proceeds of any fresh issue of shares made for the purpose of the purchase, is equal to the aggregate purchase price. For a purchase of own shares out of capital, if the permissible capital payment is less than the nominal amount of the shares purchased, the amount of the difference shall be transferred to the capital redemption reserve.

However, unlike a reduction of capital by the court which will be discussed in section 2, a purchase of own shares cannot eliminate the accumulated losses of a company or cancel any unpaid shares.

A table providing a summary of the key considerations of the above three types of purchase of own shares is set out below.

PURCHASE OF OWN SHARES

	(a) Out of Distributable Profits	**(b) Out of the Proceeds of a Fresh Issue of Shares**	**(c) Out of Capital**
Key Prerequisites	• There is sufficient amount of distributable profits *(Note 1)* to finance the purchase	• N/A	• All distributable profits have been extinguished
	• The relevant resolution for approving the transaction is ineffective if any member of the company holding shares to which the resolution relates exercises the voting rights carried by any of those shares in voting on the resolution and the resolution would not have been passed if the member had not done so	• Same as (a)	• Same as (a)

PURCHASE OF OWN SHARES

	(a) Out of Distributable Profits	(b) Out of the Proceeds of a Fresh Issue of Shares	(c) Out of Capital
Stamp Duty	• Ad valorem duty is payable on the transfer documents (the purchase of own shares is deemed to be a transfer of shares from the shareholder concerned to the company) *(Note 3)*	• Same as (a)	• Same as (a)
Protection of Creditors	• N/A • N/A	• N/A • N/A	• The directors shall make a statement, being supported by an auditors' opinion, specifying the amount of the permissible capital payment (*Note 2)* and the company's solvency within the year after the repurchase • A notice of the payment out of capital shall be published in at least the Government Gazette and a period of 5 weeks shall be allowed for objections by creditors
Accounting Treatment	• Shares being purchased shall be cancelled, resulting in a diminution of the issued capital • The amount by which the issued share capital is diminished on cancellation of the shares purchased shall be transferred to a reserve, called the "capital redemption reserve" which is of a non-distributable nature • Any premium payable on a purchase of own shares shall be paid out of distributable profits	• Same as (a) • If the aggregate amount of those proceeds is less than the aggregate nominal value of the shares purchased, the amount of the difference shall be transferred to the capital redemption reserve *(Note 4)* • Same as (a) and • If the shares to be purchased were issued at a premium, any premium payable on their purchase may be paid out of the proceeds of a fresh issue of shares made for the purpose of the purchase, up to an amount equal to:-	• Same as (a) • If the permissible capital payment is less than the nominal amount of the shares purchased, the amount of the difference shall be transferred to the capital redemption reserve • If the permissible capital payment is greater than the nominal amount of the shares purchased:- (i) the amount of any capital redemption reserve, share premium account or fully paid share capital of the company; and

PURCHASE OF OWN SHARES

	(a) Out of Distributable Profits	(b) Out of the Proceeds of a Fresh Issue of Shares	(c) Out of Capital
Accounting Treatment (cont')		(i) the aggregate of the premiums received by the company on the issue of the shares to be purchased; or (ii) the current amount of the company's share premium account (including any sum transferred to that account in respect of premiums on the new shares), whichever is the less	(ii) any amount representing unrealised profits of the company for the time being standing to the credit of any revaluation reserve maintained by the company, may be reduced by a sum not exceeding (or by sums not in the aggregate exceeding) the amount by which the permissible capital payment exceeds the nominal amount of the shares
Time Frame	• The whole process can be completed in 3 to 4 weeks, excluding additional time for application for stamp duty relief under section 45 of the Stamp Duty Ordinance, if required	• Same as (a)	• The whole process is longer than (a) or (b) and can be completed in at least 7 to 8 weeks, excluding additional time for application for stamp duty relief under section 45 of the Stamp Duty Ordinance, if required

Note 1: Distributable profits of a company are its accumulated, realised profits, so far as not previously utilised by distribution or capitalisation, less its accumulated, realised losses, so far as not previously written off in a reduction or reorganisation of capital duly made. For the purpose of determining whether a purchase may be made, reference shall be made to the company's last annual audited accounts or, in certain cases, interim or initial accounts.

Note 2: For determining the amount of the permissible capital payment, reference shall be made to the company's relevant accounts stated in Section 49J of the Ordinance, which are the accounts prepared as at any date within the period of 3 months ending with the date on which the directors' statement specifying the permissible capital payment is made.

Note 3: Stamp duty on the purchase, which is calculated at 0.2% on the purchase consideration or on the net asset value of the shares being purchased, whichever is higher, is payable to the Hong Kong Stamp Office, unless exemption is being sought. Please consult your professional advisor if you require further information in this respect.

Note 4: This does not apply if the proceeds of the fresh issue are applied by the company in addition to a payment out of capital; and in that case, the proceeds are deemed as part of the permissible capital payment.

2. REDUCTION OF SHARE CAPITAL WITH APPLICATION FOR A COURT ORDER (SECTIONS 58 TO 61 OF THE ORDINANCE)

Pursuant to Section 58(1) of the Ordinance, a company may reduce its issued share capital if:-

(a) the company is authorised to do so by its articles of association;
(b) the reduction is approved by a special resolution; and
(c) the reduction is confirmed by the court, upon the company's making of a petition to the court.

The above method can achieve the following objectives:-

- Extinguish or reduce the liability on any of the shares in respect of share capital not paid up

> e.g. In a case where 100 shares issued at HK$10 each were paid up at HK$8 per share, the company may apply for a court order under Section 59 of the Ordinance to extinguish the liability of the relevant shareholders to pay for the HK$2 unpaid on each of the shares.

- Either with or without extinguishing or reducing liability on any of the shares, cancel any paid-up share capital which is lost or unrepresented by available assets

e.g. In a case where a company has an issued share capital of 1,000,000 shares of par value HK$1 each (fully paid-up at par) and its existing net asset value per share is HK$0.8, the company may apply for a court order under Section 59 of the Ordinance to cancel 200,000 shares which are unrepresented by the company's available assets.

- Either with or without extinguishing or reducing liability on any of the shares, pay off any paid-up share capital which is in excess of the wants of the company

e.g. In a case where a company has an issued share capital of 1,000,000 shares of par value HK$1 each (fully paid-up at par) and the company intends to reduce its paid-up share capital to HK$600,000 only, the company may apply for a court order under Section 59 of the Ordinance to repay HK$400,000 to the shareholders so as to reduce the issued share capital by 400,000 shares to 600,000 shares of HK$1 each.

Key merit

The merit of this approach is that it is the only way among the alternatives mentioned in this article to eliminate the accumulated losses of a company. In the course of this reduction of share capital, the company's total issued share capital will be reduced to a designated amount such that the resulting issued share capital can be made equal to the underlying net asset value of the company whereas the accumulated losses will be removed permanently.

Disadvantages

However, this approach will involve a petition to the court, and the result of which is at the sole discretion of the court. In order to protect the creditors, the court may demand various formalities such as obtaining the consent of all the company's creditors to the reduction or having their debts or claims been discharged or secured. Accordingly, the time required may vary from a few months to over a year and the related costs are higher than the other ways.

3. REDUCTION OF SHARE CAPITAL WITHOUT APPLICATION FOR A COURT ORDER (SECTIONS 58 AND 61A OF THE ORDINANCE)

Pursuant to Section 58(3) of the Ordinance, confirmation by the court of a reduction of the share capital of a company under Section 58(1) is not required if all of the following conditions are satisfied:-

(a) the sole purpose of the reduction is to re-designate the nominal value of the shares of the company to a lower amount;
(b) the company has only one class of shares;
(c) all issued shares are fully paid-up and the amount of the net assets of the company is not less than its paid-up share capital;
(d) the reduction applies to and affects all shares equally;
(e) the amount arising from the reduction is not less than an amount representing the difference between the amount of the company's fully paid-up share capital immediately before the reduction and the amount of its fully paid-up share capital immediately after the reduction; and
(f) the amount arising from the reduction is credited to the share premium account of the company.

e.g. In a case where a company has an issued share capital of HK$1,000,000 divided into 100,000 shares of par value HK$10 each (fully paid-up at par) and the company intends to reduce its paid-up share capital to HK$600,000 only, the company may re-designate the par value of its shares from HK$10 to HK$6 per share so as to reduce the issued share capital from 100,000 shares of HK$10 each to 100,000 shares of HK$6 each. Simultaneously, an amount of HK$400,000 will be credited to the share premium account.

If you need any further information or wish to discuss the above, please approach your usual Tricor contact.

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