

## South Africa: Review of new anti-dividend stripping rules

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This Alert sets out the background to South Africa's anti-dividend avoidance rules that were introduced during 2017, the amendments made since then during 2018 as well as the new proposed rules that came into operation retroactively on 20 February 2019. Companies should take note of the circumstances in which additional tax consequences may arise, both prior to issuing new shares to third parties as well as at the time of declaring any dividends.

### Background

In 2012, South Africa implemented a new Dividend Tax regime, specifically allowing dividends declared between South African tax resident companies to be exempt from Dividends Tax. Some companies subsequently took advantage of the opportunity to extract value from subsidiary (target) companies through receiving large tax-exempt dividends. The target company shares would then be subsequently sold at significantly lower value (as the net asset value would be stripped of the pre-sale dividend), thus reducing the tax applicable on the shareholder on the sale of the target companies' shares.

During 2017 the South African National Treasury (NT) introduced anti-avoidance measures that targeted these dividend stripping schemes and extended the anti-avoidance rules to also include share buy-back avoidance schemes. However,

these rules also caught legitimate corporate reorganization transactions and NT then introduced legislation during 2018 that reversed the impact on legitimate corporate reorganization transactions.

In essence, the anti-avoidance rules curbs schemes where the following two conditions are met:

- ▶ A shareholder company (having a qualifying interest<sup>1</sup>) sells the target company shares held
- ▶ Within 18-month period *prior* to such sale received/accrued an exempt dividend constituting an extraordinary dividend (basically a dividend that exceeds 15% of the share market value)

The effect of the anti-avoidance rules is that the extraordinary dividend is deemed to be proceeds from the sale of the target company shares, which will either be included in the shareholder's company tax computation as either:

- ▶ Income tax, if the shares were held as trading stock
- ▶ Capital gains, if shares were held as capital assets

These anti-avoidance rules are contained in section 22B (from an income tax perspective) of the *Income Tax Act, No. 58 of 1962* as amended (Act) and paragraph 43A (from a capital gains perspective) of the Eighth Schedule to the Act.

## New proposed anti-dividend rules - from market value to effective interest definitions

During the Budget speech on 20 February 2019,<sup>2</sup> it was announced that NT was aware of schemes that had been devised to circumvent the current anti-avoidance rules and that changes would be introduced during the 2019 tax amendment cycle.

On 10 June 2019, NT released, for public comment, an Initial Draft Taxation Laws Amendment Bill 2019 to address the above schemes. In essence, the proposed rules would not only apply when there is a disposal of the target company's shares, but also when there is a dilution of shareholding within the target company. EY submitted a response to the initial draft amendment to NT on 21 June 2019, noting the following key concerns:

- ▶ The proposed rules potentially apply to any issue of shares at a discount if the issuing company pays large dividends - irrespective of commercial reasons for the issue

- ▶ Specific rules for determining the tax cost of the shares, treated as having been disposed of, were not provided
- ▶ Clarification was sought regarding the step up in base cost (or reduction in proceeds) for the shareholder company when it actually sold the shares (so as to avoid double taxation)
- ▶ Clarification was requested of what was meant by market value and how it should be determined
- ▶ Clarity was sought with regards to the effective date of the amendments (including whether it applied to share issues on or after 20 February 2019, even if the subscription agreement was concluded before then)

EY also attended an NT public consultation workshop on 4 July 2019 wherein NT advised that their current view was that:

- ▶ The proposed anti-avoidance rules will trigger deemed income inclusion or a capital gain (without a **tax cost offset**)
- ▶ The focus of the rules is likely to change from having a "market value" reduction trigger to an "**effective interest**" reduction trigger
- ▶ The rules would be triggered by dividend stripping, share issuance, and decrease in effective shareholding (even if only 1%)
- ▶ No special dispensation for Broad-Based Black Economic Empowerment (BBBEEE) schemes/transactions is currently considered, on the basis that diminution of effective interest represents a disposal for value
- ▶ Value shifting provisions are being re-considered, as part of a broader value-shifting anti-avoidance thrust, but will be attended to in future legislative cycles

## 2019 Draft Taxation Laws Amendment Bill (DTLAB)

NT subsequently released the 2019 Draft Taxation Laws Amendment Bill on 21 July 2019 containing, *inter alia*, proposed rules setting the requirements to capture schemes that meet the following criteria:

- ▶ **Value extraction (reducing market value of the shares) by the declaration of** a large dividend by a target company to a shareholder company that constitutes **an extraordinary dividend**<sup>3</sup>
- ▶ **Dilution** of shareholder company's **effective interest** through the target company **issuing new shares to a third party**

- Prior to the share issue, the **shareholder company had a qualifying interest**
- The extraordinary dividend occurs **within 18 months** of the share issue

The new proposed rules have the effect that the shareholder company is deemed to have disposed of a percentage of its shares held in the target company equal to the **reduction of its effective interest** in that target company. Only the **portion of the dividend relating to the deemed disposed shares** (and to the extent that it constitutes an **extraordinary dividend** will be taxed, either as revenue income or capital gains, in the hands of the shareholder company.

The proposed rules therefore do not seem to capture the full value of the dividend received by the shareholder company, but only the effective interest "reduction" portion thereof.

In addition, the DTLAB now provides that when the shareholder company actually disposes of the shares held in target company, such deemed disposal proceeds in terms of section 22B or paragraph 43A would not be taken into account again (i.e., there will not be double taxation).

The proposed rules however are silent on whether the shareholder company would receive a base cost adjustment, which implies that such base cost adjustment (whether for revenue income or capital gains) will not be taken into account. However, the base cost should at least be able to be utilized when there is an actual disposal of the target company's shares held by the shareholder company.

The determination of how one would evaluate the reduction of the effective interest, remains to be tested - (see example below).

## Effective date

The proposed new rules are proposed to come into operation retroactively on 20 February 2019 and apply in respect of shares held by a company in a target company if the effective interest held by that company in the shares of the target company is reduced, on or after 20 February 2019.

EY will again seek to clarify with NT the exact date for the implementation of the latest proposed amendments, as it is not clear whether transactions that were concluded before 20 February 2019 (but have not yet been effective for some or other reason) would fall within the ambit of the new rules or whether only transactions concluded after 20 February 2019 would only be considered.

## Practical example

Facts for this example:

*T-Co is an unlisted company and in 2015 T-Co had 100 available shares. S-Co subscribed for T-Co shares (i.e. base cost) in 2015 at 20 cents per share for all 100 shares (R20 consideration was paid in total).*

*The value per T-Co share on 1 January 2018 was 100 cents. T-Co distributed a dividend on 31 January 2019 at 80 cents per share. Post distribution on 31 January 2019 the value per T-Co share is 20 cents per share.*

*A BBBEEE Transaction was concluded wherein B-Co subscribed for 34 T-Co shares at 20 cents each (i.e. base cost) on 30 June 2019. As a result, B-Co held 25% of the shareholding in T-Co, whilst S-Co's shareholding reduced from 100% to 75%.*

## Applying the proposed new rules in the 2019 DTLAB would have the following impact:

- S Co holds a qualifying interest in T-Co (a minimum 50% shareholding in the equity and voting rights in T-Co)
- The declaration of the dividend on 31 January 2019 is within the 18-month period before the issue of the new shares to B-Co
- The effective interest of S-Co in T-Co is reduced by 25% (on a shareholding basis\*)
- The dividend would constitute an extraordinary dividend -
  - Dividend of 80 cents/share declared for each share (within an 18-month period before new shares issued)
  - Exceeds 15% higher of the market value of a share:
    - at the beginning of the 18-month period (15% of R1/ per share value on 1 January 2018 = 15 cents/per share); or
    - at the date of deemed disposal (15% of 20 cents/share = 3 cents/share)
- Hence the extraordinary dividend would be 65 cents/share (being 80 cents/share less 15 cents/share), equating to R65 based on 100 shares being held.
- S-Co would in terms of the proposed rules now be deemed to have a tax liability (without having actually disposed of its' shares) as follows:
  - **R4.55:** being R65 extraordinary dividend @ 25% (effective interest reduction) @ 28% (corporate tax rate), assuming the shares were held on **revenue account**; or

- **R3.64:** being R65 extraordinary dividend @ 25% (effective interest reduction) @ 80% inclusion rate for CGT without any base cost adjustment\*\*) @ 28% (corporate tax rate), assuming the shares were held on **capital account**

- \* *From an economic analysis perspective, S-Co's "effective interest" would remain intact provided any dilution arising from shares being issued (is at market value) such that the underlying economic value of S-Co's shares in T-Co both prior to and post the share issue would remain the same, notwithstanding the decrease in the shareholding percentage held.*
- \*\* *The taxpayer would be able to apply the base cost only at the time of the actual disposal of the shares on our reading of the draft bill provisions.*

EY will seek clarification on the above areas from NT in our responses to the DTLAB.

## Next steps

If a company has received an extraordinary dividend and its company's shareholders are intending to dispose of their shares (or intending to enter into an issue of shares to third parties), the company should consider the timing of the latter sale/shares issue. Precaution may help mitigate unwanted tax costs.

EY will be participating in further consultations with NT though it is expected that the final rules will be known only when the Taxation Laws Amendment Bill 2019 is promulgated towards the end of the year.

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## Endnotes

1. Directly/indirectly held, at least 50% (or 20% if no majority shareholders'), of the shares or voting rights in an unlisted company (or if a listed company, directly/indirectly held at least 10%.
2. As part of the 2019 Budget Annexure C tax policy proposals.
3. Dividend that exceeds 15% of the higher of the share market value at the time of the deemed disposal or 18 months earlier.

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