

Beware of tax on dividend stripping and manipulation of dividend rights



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Dividends paid by local companies are generally exempt from income tax in the hands of shareholders and, in certain cases, are either exempt from dividends tax or subject to a reduced rate of dividends tax.

Taxpayers may be tempted to enter into transactions where they either do “dividend stripping”, or manipulate the right to receive dividends to avoid income tax, capital gains tax (CGT) or dividends tax.

However, there are a number of rules in our tax law that seek to thwart those kinds of transactions.

First, if a share trader buys shares in a company, and if the purpose of the acquisition is to strip the company of its reserves, then the share trader may not be able to deduct the cost of the shares for income tax purposes. The reason is that, as dividends received from a company are exempt from income tax and accordingly do not constitute “income” for purposes of the Income Tax Act, No 58 of 1962 (Act), the expenditure to acquire the shares is not incurred “in the production of income” as required under s11(a) of the Act: Commissioner for Inland Revenue v Nemojim (Pty) Ltd 45 SATC

241.

Second, s22B of the Act applies where a company (BuyerCo) receives a dividend from a company (TargetCo) and disposes of shares in TargetCo within 18 months of receiving the dividend. The provision applies if:

- the dividend is exempt from income tax and dividends tax in the hands of BuyerCo;
- BuyerCo held the shares as trading stock;
- BuyerCo held more than 50% of the equity shares in TargetCo; and
- TargetCo (or its direct or indirect subsidiary), within a period of 18 months before the disposal, by reason of the disposal, has borrowed money from BuyerCo (or a person connected to BuyerCo), or has borrowed money from a third party that is guaranteed by BuyerCo (or a person connected to BuyerCo).

If the requirements of s22B of the Act are met, then the dividend is not exempt from income tax in the hands of BuyerCo. The amount included is limited, however, to the amount of the debt.

Essentially, the provision is aimed at transactions where the person acquiring shares funds the pre-sale dividend in the case where the company paying the dividend has no available cash, and the person then has a loan in the company which it can strip out free of tax.

Third, paragraph 43A of the Eighth Schedule to the Act may apply in the case where BuyerCo held the shares on capital account, and the disposal is subject to CGT. The requirements of that provision are materially similar to those of s22B of the Act. However, the effect in this case is, essentially, that BuyerCo must account for CGT on the dividend as though it were proceeds on the disposal of the shares.

Note that the above provisions may also apply where TargetCo

buys back shares from BuyerCo.

Fourth, another 18-month, anti-dividend stripping rule is contained in paragraph 19 of the Eighth Schedule. Under that provision, a shareholder must disregard a capital loss for CGT purposes if, within 18 months before the disposal, or as part of the disposal, the shareholder received "extraordinary exempt dividends". Dividends constitute "extraordinary exempt dividends" if they are exempt from income tax and dividends tax in the hands of the shareholder, and if they exceed 15% of the proceeds on disposal.

Fifth, if the right to receive a dividend (without the underlying share) is transferred to a company, then the dividend is not tax exempt in the hands of the company: proviso (ee) to s10(1)(k) of the Act. The purpose of the provision is, essentially, to prevent a person from stripping a company of reserves without holding an interest in the underlying share.

There is a similar provision relating to dividends tax. If, in certain cases, a resident company, tax-exempt person or non-resident acquires the right to a dividend by way of cession (without the underlying share), and if the dividend is declared (but not paid) before the acquisition, the person that has ceded the right is deemed to be the beneficial owner of the dividend and, accordingly, must account for dividends tax on the dividend: s64EB(1) of the Act.

Sixth, in certain cases, dividends received by a company are not tax exempt where the company borrows the shares and receives a dividend on the borrowed shares: provisos (gg) and (hh) to s10(1)(k) of the Act. Section 64EB(2) of the Act provides for a similar provision for dividends tax purposes where, in certain cases, a resident company, tax-exempt person or non-resident borrows, or enters into a resale agreement in relation to a listed share.

Finally, under s181 of the Tax Administration Act, No 28 of 2011 a shareholder may become liable for the tax debts of the company if the shareholder receives a dividend (or other distribution of assets) from the company within one year before its winding up and the company had outstanding tax debts at the time of the distribution. The provision is no doubt aimed at shareholders stripping a company of its assets by way of a distribution when they know that the company has outstanding tax obligations. The provision is discussed in greater detail in our Tax Alert of 7 June 2013: Shareholders liable for tax debts of companies on winding up.

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