Dividends ceded to companies not exempt from income tax

Dividends are generally exempt from income tax, subject to the exceptions contained in s10(1)(k)(i) of the Income Tax Act, No 58 of 1962 (the Act).

The Taxation Laws Amendment Act, No 24 of 2011 (the TLAA) introduced a new exception to the dividend exemption, namely ceded dividends.

In terms of a new paragraph (ee) to the proviso to s10(1)(k)(i) of the Act (effective 1 April 2012) the dividend exemption will not apply "to any dividend received by or accrued to or in favour of a company in consequence of:

any cession; or
any right of that company acquired in consequence of any cession".

In its simplest form, a cession is a transfer of a right. Often persons cede (transfer) their right to receive dividends in respect of shares to other persons without actually transferring the shares. If a person ceded the right to dividends to a company, then the dividend will, with effect from 1 April 2012, not be exempt from income tax in the hands of the company. Importantly, the provision contained in s10(1)(k)(i)(ee) of the Act is only applicable to ceded dividends received by or accrued to a company and not individual taxpayers.

In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 (Explanatory Memorandum) dated 27 January 2012 (at pages 60 and further) the National Treasury says it had to introduce the provision above because taxpayers often cede dividends to avoid tax. Further, as the person receiving the right (cessionary) has no "meaningful interest" in the

underlying shares, the person should be fully taxed.

So far, so good. However, at page 63 of the Explanatory Memorandum, National Treasury proceeds to make a startling proposal. It says that, if a company is a beneficiary of a discretionary trust, which holds shares, and the trustees decided to allocate dividends in respect of the shares to the company beneficiary, then the dividends will be subject to income tax by virtue of paragraph (ee) to the proviso quoted above because the “company never holds a vested interest in the underlying ordinary shares”.

The proposal must be wrong. If a trustee of a discretionary trust decides to vest income (for instance, dividends) in a beneficiary, there is no question of a “cession”, a transfer of a right, as required by paragraph (ee) to the proviso (see also Haupt Notes on South African Income Tax Act 2012 edition at page 93).

More importantly, in terms of the common-law “conduit principle” and the provisions of s25B(2) of the Act, a dividend allocated to a beneficiary of a discretionary trust in the tax year it is received retains its nature as a dividend and is deemed to be derived for the benefit of the beneficiary. While the ruling relates to legislative references of the Act as at 1 January 2011, Binding Class Ruling No. 31 confirmed, based on the particular transaction, that:

any distribution made by the trustees of the discretionary trust to the beneficiaries will, if distributed within the same year of assessment in which the dividend was received by or accrued to the trust, retain the character of a dividend in the hands of the beneficiaries; and
such dividends will be exempt in the hands of the beneficiaries under s10(1)(k)(i) of the Act.

Taxpayers contemplating entering into cession of dividend

transactions must therefore be mindful of the new proviso to s10(1)(k)(i) of the Act and SARS' interpretation of how the dividend exemption should be applied.