Major new tax burden introduced

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The Taxation Laws Amendment Act of 2017 (Act 17 of 2017) which was promulgated on 18 December 2017 contains provisions, namely section 22B of the principal Income Tax Act and paragraph 43A of the Eighth Schedule to the Income Tax Act, that will result in a significant compliance burden for companies, even in cases in which they do not result in additional taxation. The provisions deal with disposals of shares in a company (say A) that are held by another company (say B) in circumstances in which B held a significant portion of the equity shares (which the Amendment Act defines as a qualifying interest) in A at any time within the 18 months preceding the disposal. Section 22B applies in situations in which the shares that are the subject of the provision are held as trading stock while paragraph 43A of the Eighth Schedule applies in situations in which the shares are held as capital assets.

Essentially, any untaxed dividends (dividends that were exempt from income tax and also not subject to dividends tax) that were received by or that accrued to B during the 18 month period prior to the disposal, or in respect, by reason, or in consequence of the disposal, that are considered extraordinary in amount (which the Amendment Act defines as an extraordinary dividend), must be added to the proceeds on disposal of the shares for capital gains tax purposes. So for example if B held 50% of the equity shares in A and sells any shares held in A, then in calculating Bs capital gain on the disposal it would take into account its actual proceeds plus any extraordinary dividend which it had received or to which it became entitled.

The provision has been backdated to 19 July 2017, which implies that dividends that were received or accrued up to 18 months prior to that date may be subject to taxation if shares are disposed of on or after that date. There is however a carve-out if all the terms to the share disposal agreement were finally agreed to before 19 July 2017 by all parties to that agreement.

A substantial compliance burden is implied in that, in determining whether a dividend is an extraordinary dividend, one has to value the shares that are disposed of in order to determine the market value of the shares on the date 18 months prior to the disposal and then value the shares again at the date of disposal. It is often a difficult, costly and time-consuming exercise to value shares, especially a retrospective valuation such as at a date 18 months prior to the date of disposal of the shares.

Where there is only a holding of equity shares, the methodology to determine whether a dividend is an extraordinary dividend is as follows: If the market value of the shares 18 months prior to the date of disposal is C and the market value of the shares on the date of disposal is D, then the higher of C and D is chosen. One takes 15% of this figure. An extraordinary dividend is so much of any dividend received or accrued within 18 months prior to the disposal of the shares, or in respect, by reason, or in consequences of the disposal, as exceeds the 15% figure determined above. The provision requires that any untaxed dividend that was received or that accrued within 18 months of the date of disposal, or in respect, by reason, or in consequences of the disposal, must, to the extent that the untaxed dividend is an extraordinary dividend (i.e. the excess of the dividend over the 15% figure determined above) be treated as additional proceeds on the disposal of the shares. The wording of the provision suggests that each individual dividend received or accrued has to be tested against the 15% figure on an individual basis in order to determine whether that dividend is an extraordinary dividend i.e. that one does not aggregate the dividends received or accrued within the 18 month period and test the aggregate of such dividends against the 15% figure. This is likely an oversight.

The initial proposal contained in the Draft Taxation Laws Amendment Bill released in July 2017 was substantially similar, although an important difference was that there was no extraordinary dividend test. The initial proposal was thus that any untaxed dividends that were received or that accrued within the 18 month period were to become additional proceeds. Both the initial proposal and enacted provision are aimed at share buy-backs and the common practice of dividend stripping whereby companies receive untaxed dividends instead of taxable proceeds upon the disposal of shares. However, the provision is not limited to share buy-backs and applies to any disposal of shares. It would therefore apply if the disposal was by way of an outright sale of shares and even if the extraordinary dividend was unrelated to the sale.

The insertion of the extraordinary dividend test represents a better outcome for taxpayers than the more draconian initial proposal. However, it implies a substantial compliance burden even in the case of normal business transactions such as third party sales of shares. In view of the fact that the Tax Administration Act places the burden of proving that an amount should not be subject to tax on the taxpayer rather than on SARS, taxpayers would be ill-advised not to conduct the valuations to which the provision refers.

The definition of qualifying interest is central to the application of the provision in that a qualifying interest must be held at any time within 18 months prior to the disposal of the shares for the provision to apply. In the case of a listed company, the definition of qualifying interest contemplates an equity or voting interest of at least 10 per cent. In the case of an unlisted company, an equity or voting interest of at least 50 per cent (or 20 per cent if no other person holds the majority equity shares or voting rights), whether alone or together with connected persons in relation to the holder, must be held.

It should be noted that the provision could still apply in sell-down situations where a qualifying interest was held at some point during the 18 month period but not on the date of disposal of the shares in question. So for example, even if only a 5 per cent interest is disposed of, the provision could apply if at any point in the 18 month period prior to the disposal a qualifying interest was held.

The provisions have the further undesirable consequence that they have been added to the list of provisions that override the corporate restructuring rules contained in Part III of the Income Tax Act. So for example in an intra-group liquidation transaction under section 47 of the Income Tax Act, one will need to assess whether proceeds will need to be taken into account upon liquidation of the transferring (subsidiary) company. However the override of the corporate rules is not limited to section 47 transactions but potentially may include any corporate rollover transaction in which there is a disposal of shares and the other requirements of the provisions are met. This will add considerable complexity in the application of the corporate restructuring rules and may discourage taxpayers from utilising these rules, the purpose of which was to bring South Africas tax regime into line with international practice. If a disposal of shares would otherwise be capable of occurring on a tax neutral basis in terms of the corporate restructuring rules, it is unclear why a taxpayer should be penalised by having to pay tax on extraordinary dividends declared. Had the extraordinary dividends not been declared, the value of the shares disposed of would presumably have been higher but such disposal is in any event permitted as a tax neutral disposal under the corporate restructuring rules. Put differently, if a disposal of shares will qualify for relief from capital gains tax under the corporate restructuring rules, there is no incentive for taxpayers to attempt to dividend strip a company prior to such disposal in order to reduce the capital gain.

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