The death of share buy-backs?

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Share buy-backs have become very popular over the last few years in circumstances where a taxpayer intended to dispose of his shareholding in a company. This was especially the case to the extent that the seller is also a company. The reason is that, should one consider the definition of a dividend in s1 of the Income Tax Act, No 58 of 1962 (Act), the proceeds from a share buy-back will be deemed to be a dividend to the extent that it is not funded out of so-called share capital or contributed tax capital (CTC). To the extent that the seller is a company, such dividend would also not be subject to dividends tax at the rate of 20% given the fact that a dividend to a resident company is exempt from dividends tax. Instead of thus paying capital gains tax (CGT) at normal company rates of 22,4%, the seller effectively divested itself of the shares in the target company and in the process received an exempt dividend.

Ironically, non-resident shareholders and individual shareholders did not opt for the share buy-back alternative given the fact that:

- a non-resident shareholder is more often than not, not subject to CGT given the fact that the proceeds will not be taxable in South Africa unless one is dealing with a so-called property rich company;

- an individual pays CGT at the rate of 18% compared to the 20% dividend withholding tax that would arise had the individual received a dividend; and
- billions of Rand of transactions have been entered into in this manner on the basis that any conceivable reason was advanced to enter into a share buy-back arrangement as opposed to an outright sale of shares. It must be noted, however, that in both instances securities transfer tax at the rate of 0,25% would be payable.

The legislature acts

In terms of the Draft Taxation Laws Amendment Bill, 2017 (Bill) drastic
anti-avoidance measures are introduced. The current anti-avoidance provisions were limited to a scenario where there was a share buy-back linked with a subscription of shares by the purchaser of the target company. In other words, it only applied to very limited circumstances. The new anti-avoidance measures which will apply with reference to disposals on or after 19 July 2017 are aimed to take into account the following:

- variations to the share buy-back structure pursuant to which sellers avoided income tax or CGT on the outright sale of shares;
- the limited scope of the current anti-avoidance provisions that only focused on debt funding advanced or guaranteed by a prospective purchaser or a connected person in relation to the prospective purchaser to fund the share buy-back; and
- the limited scope of the dividend stripping rules in the sense that they only applied to a scenario where a seller held more than 50% of the shares in the target company.

The proposal

The proposal contained in the Bill is aimed at a scenario where the shares are both held as trading stock as well as on capital account. Essentially the proposal is that dividends that are received within 18 months of the disposal, must be added to the proceeds and thus are subject to CGT or income tax, as the case may be. The dividends are thus not exempt from tax. However, at least there will not be an additional dividends tax that will apply.

The following circumstances must exist before the anti-avoidance rules will apply:

- the seller must be a resident company. In other words, if one is dealing with a non-resident shareholder, the aim is that it will receive a dividend which is subject to dividends tax at the rate of 20% or such other rate as may be applicable in terms of the relevant treaty. If one had extended the anti-avoidance rules to a non-resident shareholder, it would effectively have meant that the non-resident shareholder would not pay any tax given the fact that it is not liable to tax on the proceeds of the sale of shares in a company unless the company is a property rich company;
- the seller (together with connected persons in relation to the seller) must hold at least 50% of the equity shares or voting rights in the target company or at least 20% of the equity shares or voting rights in the target company if no other person holds the majority of the equity shares or voting rights. In other words, the scope is now much wider as the anti-avoidance rules could also be applicable if one holds 20% of the shares in the target company and nobody holds the majority of the equity shares (ie more than 50%);
- a dividend is received or accrues within 18 months prior to the disposal of the shares in the target company or is received or accrues, regardless of the time of the receipt or accrual, by reason of or in consequence of

> the disposal of the target company shares. In other words, even if one receives a dividend subsequently and it is linked to the overall disposal, the dividend will still be added to proceeds.

It is important to appreciate that there is no longer a focus on the way in which the dividend is funded or whether there is also a subscription for shares. The only test now is whether one has received an exempt dividend within an 18 month period, in which event the dividend will be added to proceeds.

Given the fact that the amendment applies with effect from 19 July 2017, agreements that may have been entered into prior to this date but have not become unconditional, will also be covered by the anti-avoidance provisions. The reason is that a disposal is understood to be an agreement which is unconditional or an agreement the suspensive conditions of which have been fulfilled. Taxpayers will thus have to consider their agreements urgently so as not to fall foul of the proposals.

It should be appreciated that comments are still awaited in respect of the proposals. National Treasury can expect to be flooded with comments on this provision, even though taxpayers have been warned about this potential abuse for a number of years.

It should be appreciated that, even in its current format, the proposal has limited application. The reason is that, to the extent that one is dealing with a minority shareholder, a buy-back can still be implemented. It is only if one holds more than 50% of the shares in the target company or more than 20% if no other person holds the majority of the equity shares, that the proposal will become applicable.

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