Employee share schemes: Tax deductibility of employer contributions

Ben Strauss (Director at Cliffe Dekker Hofmeyr).

Many employee share incentive schemes work as follows: The employer company forms a scheme trust. The company pays a non-refundable cash contribution (or grant) to the trust (instead of, say, lending cash to the trust). The trust uses the cash to buy, or subscribe for, shares in the employer company or another related company. Eligible employees are given the opportunity to participate in the scheme by, say, acquiring units in the trust, subject to the employees continuing to comply with certain conditions over a number of years.

As long ago as 2009, the South African Revenue Service (SARS) ruled that an employer who makes cash grants to a share scheme trust may deduct the amount of the grants in terms of the general deduction provision in s11(a) of the Income Tax Act, No 58 of 1962 (Act) (see SARS Binding Private Ruling 050 dated 16 October 2009 (BPR 050)). One should note that BPR050 only applied to its specific facts.

The deductibility of employer contributions or grants was the subject of a recent case in the Cape Town Tax Court, *S G Taxpayer v Comissioner for the South African Revenue Service*, Case No IT 14264.

The facts in the case were the following: The taxpayer, an operating company, (OpCo) established an employee share

incentive scheme (Scheme) for its employees. Under the Scheme, a company (HoldCo), the holding company of OpCo, formed a trust (Trust). The Trust was a discretionary trust. HoldCo was the sole beneficiary of the Trust.

A new company was formed by the Trust (NewCo). The employees of OpCo were offered and acquired shares in NewCo. The NewCo shares were subject to certain lock-in provisions in respect of the employees.

OpCo and the Trust concluded a contribution agreement. Under the agreement, OpCo agreed to contribute a non-refundable amount (Contribution) to the Trust. The Trust had to use the Contribution to incentivise eligible employees in accordance with the Scheme rules and, for that purpose, used the Contribution to subscribe for redeemable preference shares (NewCo Prefs) in NewCo.

NewCo, in turn, used the subscription price of the NewCo Prefs to buy shares in HoldCo.

Over time, the value of the shares in HoldCo increased significantly. NewCo decided to redeem the NewCo Prefs by transferring HoldCo shares to the Trust. NewCo sold shares in HoldCo and paid dividends to the Scheme participants.
OpCo claimed the Contribution as a deduction against its taxable income in terms of s11(a) of the Act. Initially, SARS allowed the deduction. Subsequently, however, it issued an additional assessment disallowing the deduction. SARSs reason for disallowing the deduction was that HoldCo was the sole beneficiary of the Contribution as it (as beneficiary of the Trust) would benefit from the investment in the NewCo Prefs (through redemption and dividends); and the Scheme participants did not benefit from the Contribution. SARS argued that the Contribution paid by OpCo was accordingly not incurred in the production of its income, as required under s11(a) of the Act as there was no direct causal link between the payment of the Contribution and the production of income

from the Contribution.

The Tax Court referred to certain well-established principles, namely, that the test is not whether there is a causal link but whether there is a sufficiently close connection between the expense and the income; that it is not necessary for the taxpayer to show that a particular item of expenditure produced any part of the income; and that, provided the taxpayer can show that the purpose of the expense was to produce income, any incidental benefit to a third party does not preclude the taxpayer from deducting the expense.

The Tax Court heard evidence from the auditor who advised on the Scheme, and from a participant in the Scheme.

The Court held as follows (at paragraphs 46 and 49):

On the evidence, the dominant purpose in the establishment and implementation of the scheme was to protect and enhance the business of the taxpayer [OpCo] and its income, by motivating its key staff to be efficient and productive and remain in the taxpayers employ. …

The mere fact that the taxpayer foresaw that HoldCo would potentially also benefit from the redemption of the NewCo preference shares cannot negate the taxpayers purpose and intention, which was actually effected by the scheme insofar as the value of the NewCo shares increased significantly, and this benefit, together with the dividends declared by NewCo on the remaining HoldCo shares following the preference share redemption, actually accrued to the scheme participants. The increase in the value of the HoldCo shares is directly attributable to the increase in the turnover and profits of the taxpayer, being the main operating subsidiary of HoldCo.

The Court accordingly held that there was a sufficiently close link between OpCos expenditure of the Contribution and its income-producing operation.

The judgment is good news for taxpayers. However, the following should be noted:

- The Court quoted extensively from the Contribution agreement. It was apparent that the agreement was carefully drafted and set out the rationale for the Scheme and the Contribution in detail. In other words, when setting up an incentive scheme, it is critical that employers document the purpose and operation of the scheme meticulously.
- In the Tax Court case, the advisors on, and the participants in, the Scheme clearly had a good understanding and recollection of the way the Scheme worked and the purpose of the Scheme. Accordingly, it is important that taxpayers, when setting up a share incentive scheme for employees, obtain and retain comprehensive written advice from professionals in relation to the manner in which the scheme should operate and what the incidence of tax will be for all parties in the scheme.
- A contribution or grant in such cases must be spread over the period of the anticipated benefit to be derived by participants in terms of 23H of the Act (as pointed out by SARS in BPR 050 and as was done by OpCo in the Tax Court case).

Hybrid Equity Instruments: Redemption versus repurchase

Author: Leani Nortje, a Senior Associate at Webber Wentzel.

Section 8E of the Income Tax Act, 1962 (the Act) applies to *inter alia* deem a share to be a hybrid equity instrument if certain requirements are met, with the result that otherwise exempt dividends paid in respect of that share are deemed to be fully taxable income.

One of the requirements that must be met for purposes of section 8E to apply is that the issuer of the share must be obliged to redeem the share in whole or in part, or the share may at the option of the holder be redeemed in whole or in part, within three years from the date of issue of the share. Section 8E therefore requires a “redemption” of the relevant shares.

As the Act does not define a “redemption” and a “repurchase”, the question arises whether SARS will seek to apply the provisions of section 8E where shares are repurchased as opposed to redeemed.

In the case of A *(Pty) Ltd v Commissioner for SARS (Case No 12644), 2012* SARS argued that, in essence, a redemption is a kind of “buy-back” and that there is no difference between the redemption of shares and a share buy-back. As the case on hand was decided on a different point, the court did not think it necessary to decide on the difference between a redemption of

shares and a buy-back or a repurchase of shares.

Practically, however, there is a difference in the meaning of these terms. The redemption of shares results in the extinction of rights whereas a repurchase of shares results in a transfer of the rights embodied in the shares. It is, accordingly, arguable that where shares are repurchased as opposed to redeemed the provisions of section 8E cannot apply as a repurchase is a separate and distinct event from a redemption.

In SARS Binding Class Ruling: BCR 044 (2014), the applicant was a public company listed on the Johannesburg Stock Exchange (JSE) that issued non-redeemable and non-participating preference shares to certain persons (the Class Members). The applicant subsequently decided to repurchase the preference shares from Class Members at their current market value as traded on the JSE. SARS made various rulings in respect of the transaction, but in particular, ruled that the preference shares would not be recharacterised as hybrid equity instruments for purposes of section 8E merely by reason of their repurchase by the applicant, and that dividends paid by the applicant during the relevant financial year of assessment would therefore not be recharacterised as income in the hands of the Class Members.

Based on BCR 044, it would seem that SARS agrees that there is a difference between a redemption and a repurchase, but unfortunately, binding class rulings are only binding on the particular Class Members and cannot be relied upon by other taxpayers. Consequently, taxpayers must take care when drafting the terms of a redemption or repurchase of shares and rather take the more conservative approach and assume that

SARS may seek to apply the provisions of section 8E broadly, so that a repurchase (although different from a redemption in practice) will be treated akin to a redemption for purposes of section 8E.

Major new tax burden introduced

Author: David Warneke (Partner and head of Tax Technical at BDO South Africa).

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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Consecutive asset-for-share transactions

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Section 42 of the Income Tax Act, No 58 of 1962 (Act) allows taxpayers to transfer assets to a company free of immediate tax consequences, provided certain requirements are met; there is a roll-over for tax purposes. However, certain anti-avoidance provisions may be triggered if the company that acquired the assets, disposes of the assets within 18 months of acquisition.

A question that has often been posed is whether the anti-avoidance provisions will apply if the company that acquired the asset, within 18 months of the acquisition, disposes of those assets to another company in terms of an asset-for-share transaction under s42 of the Act.
The South African Revenue Service (SARS) has provided some guidance in Binding Private Ruling 288 (BPR 288).

In BPR 288 the taxpayer sought a ruling from SARS on the following proposed transactions.

Company A is a local company. The shares in Company A are held (i) as to 89.8% by Company B, a foreign company, and (ii) as to 10.2% by the managing director (MD) of Company A.

A new shareholder (X) will buy 6.5% of the shares in Company A from Company B and the MD in proportion to their shareholding in Company A. The price will be market-related.

X will then transfer the shares it acquired in Company A to Company Q, a local company, in exchange for shares in Company Q.

Company B and the MD will then dispose of 19.5% of their shares in Company A to Company R in exchange for shares in Company R in quantities proportionate to their respective shareholding in Company A. Company B will transfer those shares as an asset-for-share transaction under s42 of the Act. Company R intends holding the shares in Company A on capital account.

The subsequent transaction is the tricky one: Company R will promptly transfer its shares in Company A to Company Q in exchange for shares in Company Q. Company R will transfer those shares in terms of an asset-for-share transaction under s42 of the Act. Company R will then hold 75% of the shares in Company Q. The remaining shares in Company Q will be held by X.

The rulings of SARS that are notable are the following:

- First, in the circumstances of the matter, Company R will be seen to hold the shares in Company A on capital account even though it will dispose of the shares in Company A to Company Q shortly after it acquired the shares.
- Second, in principle, the 18-month anti-avoidance rule will apply to the disposal by Company R of its shares in Company A to Company Q. However, practically, no gain or loss will arise as the shares in Company A will be transferred at the cost at which they have been acquired.
- Third, the second asset-for-share transaction, that is, the transfer by Company R of its shares in Company A to Company Q, will qualify as an asset-for-share transaction under s42 of the Act.

What the ruling essentially says is this: if a taxpayer transfers a capital asset to a company in exchange for shares in that company and the requirements of s42 of the Act are met; and if the company then promptly disposes of that capital asset to another company in exchange for shares in that other company and the requirements of s42 of the Act are met then both transactions may qualify for tax roll-over relief.

A word of warning though: SARS made it very clear that the ruling in BPR 288 was specific to the facts in the matter. BPR 288 accordingly is not a licence for taxpayers to do successive asset-for-share transactions under s42 of the Act in all cases. Taxpayers would still in each case need to take specific advice from tax professionals before implementing such transactions.

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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.

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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Ruling on unitised incentive scheme does not provide much clarity

An employee incentive scheme that is commonly used works as follows: A company forms a trust. The company funds the trust, and the trust then uses the funds to buy shares in the company. The employees of the company are given units in the trust, usually free of charge. The units entitle the employees to receive distributions from the trust on the underlying shares. The employees forfeit their units in certain circumstances and may generally not dispose of their units. The trust may "repurchase" the units from the employees in certain circumstances.

Section 8C of the Income Tax Act, No 58 of 1962 (Act) generally applies to such schemes. Put simply, that provision states that, if an employee acquires a restricted equity instrument by virtue of her employment, she must pay income tax (and not capital gains tax (CGT)) when the instrument vests.

An equity instrument includes not only a share but also a unit in a trust as indicated above.

An instrument will be restricted if the employee may not freely dispose of the instrument, or forfeits it when the employee leaves the employment of the company within a specified period or is dismissed for cause.

An instrument vests when the restrictions that apply to the instrument come to an end.

The income tax is determined on the difference between the amount (if any) paid by the employee to acquire the instrument and the market value of the instrument at the time it vests.

The company or the trust must withhold employees' tax (PAYE)

on the amounts accruing to the employees.

The application of s8C of the Act is generally relatively clear in schemes such as the one described above.

What is not always clear is the interaction between s8C of the Act and the incidence of tax in the hands of the trust.

A scheme similar to the one described above was the subject of Binding Private Ruling No 261 (Ruling), issued by the South African Revenue Service (SARS) on 30 January 2017. The trust repurchased the units of the employees. However, to fund the repurchase price, the trust had to sell some of the shares in the company.

SARS ruled as follows:

- The proceeds received by the trust on the disposal of the shares accrue to the trust, which must calculate any capital gain or capital loss arising on the disposal.
- For CGT purposes the trust must reduce the base cost of the shares by the amount of the contributions made by the relevant companies to enable the trust to acquire the shares. This must be done under paragraph 20(3)(b) of the Eighth Schedule to the Act (Eighth Schedule) which states, among other things, that a taxpayer must reduce the cost of an asset by any amount that has been paid by any other person.
- If the trust realises any capital gains on the disposal, those gains will not be taxable in the trust under paragraph 80(2) of the Eighth Schedule. Paragraph 80(2A) of the Eighth Schedule will not apply.
- As the repurchase of the units results in vesting, s8C of the Act will apply and any gain determined in respect of the vesting is subject to employees' tax, which the trust must withhold.

Paragraph 80(2) of the Eighth Schedule essentially provides that, where a trust realises a capital gain on the disposal of

an asset, and the beneficiary has a vested interest in the capital gain but not in the asset, the beneficiary (and not the trust) must account for CGT.

Paragraph 80(2A) of the Eighth Schedule applies where a beneficiary of the trust holds an equity instrument to which s8C of the Act applies. The provision states that, in that case, paragraph 80(2) of the Eighth Schedule does not apply in respect of a capital gain that is vested in the beneficiary by reason of (i) the vesting of that equity instrument in the beneficiary, or (ii) the disposal of that equity instrument under s8C(4)(a) and s8C(5)(c) of the Act.

In this regard, the Ruling suggests that paragraph 80(2) of the Eighth Schedule will apply in respect of any gains realised on the disposal of the shares, and must be disregarded by the trust where the gains are vested in the beneficiaries. However, the Ruling is silent as to whether any such gains must be taken into account for purposes of calculating the beneficiaries' aggregate capital gains or losses. The Ruling does not explicitly state whether the beneficiaries should account for CGT.

It is possible that SARS is saying that there is no CGT at all, and that the only tax that arises is income tax in the hands of the beneficiaries on the repurchase of the units under s8C of the Act.

Unfortunately, the Ruling does not provide certainty on the interplay between CGT and income tax in schemes such as that described above. Generally, that issue is a vexed one and greater clarity from SARS or the legislature would be very welcome.

Tax and Exchange Control Alert

03 Feb 2017 by Ben Strauss
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Beware of tax on dividend stripping and manipulation of dividend rights

Author: Ben Strauss.

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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the draft reviewed Mining Charter: Employee share ownership plans and the ownership element – playing

the waiting game?

One of the key elements addressed in the Draft Reviewed Broad Based Black-Economic Empowerment ("**BBBEE**") Charter for the South African Mining and Minerals Industry, 2016 (the "**draft reviewed Mining Charter**") is the issue of ownership.

The Department of Mineral Resources ("**DMR**") seeks to achieve the ownership requirement through broad-based employee share option plans ("**ESOPs**"), which are likely to have an impact on both mining companies and their employees from a tax perspective.

The DMR published the draft reviewed Mining Charter in April, following an assessment of compliance by mining companies with the Amended Mining Charter of 2010. According to the preamble of the draft reviewed Mining Charter, this assessment revealed the following regarding the ownership element of the Mining Charter:

"Limited progress has been made in embracing the broad-based empowerment ownership in terms of meaningful economic participation of black South Africans. The trickle flow of benefits that ought not only to service the loan, but also include cash-flow directly to BEE partners, is vastly limited. To this end, the interests of mineworkers and communities are typically held in nebulously defined trusts, which constrain the flow of benefits to intended beneficiaries. As a result, the mining industry has broadly been faced with increasing tensions with both workers and host communities."

In response to this, the draft reviewed Mining Charter provides that stakeholders in the mining industry must achieve

a minimum target of 26% ownership per mining right to enable meaningful economic participation of black people. In respect of employees, this 26% stake must include a minimum of 5% shares equitably distributed among employees (in the form of ESOPs). This stake will be held in trusts created by the employees, and the trusts will have to be represented by unions and report to the South Africa Revenue Service and the DMR.

Shareholders of the black empowerment stake (i.e. the trusts in the case of ESOPs) must also create a special purpose vehicle ("**SPV**") to manage the 26% black economic empowerment stake according to its own memorandum of incorporation, which addresses issues such as the appointment of joint representatives, allocation of voting rights, and dispute resolution. Further, the draft reviewed Mining Charter envisages that there must be a BBBEE transaction for each mining right granted and one SPV for each empowerment transaction. The mining right holders must, with the concurrence of the black economic empowerment ("**BEE**") partners, consolidate the empowerment transactions with the prior written consent of the Minister of Mineral Resources.

The draft reviewed Mining Charter was open for public comment by interested and affected parties until 31 May 2016. In addition, the DMR has been in discussions with stakeholders since the draft reviewed Mining Charter was published, and it has promised a revised draft reviewed Mining Charter that will incorporate what has been agreed with the stakeholders. However, It is unclear when this revised version will be published and whether it will be in final form, promulgated and effective without further consultation.

The broad-based employment requirement of the ownership element is, however, likely to remain in the final version. This is because there are various advantages in implementing ESOPs to obtain and maintain BBBEE ownership in businesses. One such advantage for the employer company is a tax deduction

of the cost of the BBBEE structure. However, this deduction may need to be spread over the period of the ESOP. The draft Taxation Laws Amendment Bill, which was published for comment on 8 July 2016, proposes a new section 8CA for the Income Tax Act,1962. This section provides for the deduction of the expenditure incurred in respect of a restricted equity instrument scheme. The deduction will be spread over the period that the equity instrument is restricted. The proposed section also provides for a recoupment of the deduction when an employee leaves the employment of the employer. This proposed section could be problematic if the ESOP's term is lengthy or if the scheme is structured to be restricted indefinitely to ensure prolonged fulfilment of the objectives of the Mining Charter and BBBEE legislation. Another advantage is that employees could be locked in easier than other BEE partners, which is beneficial for the employee and the mining company, as the risk of having to restructure BEE ownership every couple of years is reduced. Also, the ESOP could be structured to be flexible to meet the respective organisation's circumstances and the Mining Charter requirements.

Even though the draft reviewed Mining Charter may look different in its final form, one thing that will remain is the need to address the ownership element, and the tax implications for employees and mining companies. Notwithstanding the benefits of an ESOP, various changes to tax legislation in recent years have made it increasingly difficult to structure BBBEE shareholding where employees are involved, in a manner that employees are taxed on gains and dividends, as shareholders and owners of the business (i.e. capital gains tax and dividends tax), as opposed to being taxed on the gain and dividends similar to a bonus (taxed at the marginal rate of the employee, which is often a higher rate than tax on capital gains and the dividends tax rate). The proposed changes to section 8C in the draft Taxation Laws Amendment Bill seek to cast the net even wider. It is proposed

that dividends consisting of proceeds from the disposal or redemption of any underlying equity shares to the restricted equity instruments will be included in the income of the employees.

This treatment is inconsistent and counterproductive to the objectives of the Mining Charter and BBBEE legislation, with regard to broad-based ownership opportunities for employees of mining businesses.

For many years, the Minister of Finance has mentioned in the annual Budget Speech that National Treasury is looking at reforming the legislation dealing with ESOPs. One hopes that the country's BBBEE objectives are taken into consideration during this process. At this stage, it appears that the changes coming through in the amendments to the taxation laws relating to share schemes merely seek to cast the net wider with regard to amounts being included in the income of employees, as opposed to enhancing the taxation laws to bring them in line with, and to promote, the country's BBBEE objectives.

In the meantime, and even more so if the changes in the draft Taxation Laws Amendment Bill are implemented, taxpayers should seek advice from tax professionals who understand and have extensive experience with regard to the complex tax legislation pertaining to ESOPs and broad-based share plans, and who understand and appreciate the requirements and complexities of the Mining Charter, the Mineral and Petroleum Resources Development Act and the BBBEE Act.

Further, tax professionals must ensure that the proposed structure is properly implemented in light of the many ingenious structures being incorrectly implemented, with abysmal consequences for mining companies and employees.

For more information on the draft reviewed Mining Charter, click here and here.

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SARS rules again on the capitalisation of loan accounts

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The South African Revenue Service (SARS) has now issued a

number of rulings on the matter of the “conversion” of debt to equity.

We have discussed previous rulings on this topic in our Tax Alerts of 15 January 2016 and 9 October 2015.

On 31 May 2016 SARS issued Binding Private Ruling 236 (Ruling) which again deals with the issue.

The Ruling involved a restructure of a group of companies. As part of the restructure, one company in the group (African Holdco) acquired a loan account in its wholly-owned subsidiary company (Foreign Holdco). Notably, African Holdco was a tax resident in South Africa, while Foreign Holdco was a tax resident in another country.

The restructure worked as follows:

- First, a company in the group (Applicant) sold certain shares to another company in the group (Foreign Holdco). The price was left owing on loan account (Loan).
- Second, the Applicant distributed the Loan to its holding company (Holdco) as a dividend in specie.
- Third, Holdco subscribed for further ordinary shares in the capital of African Holdco for a subscription price equal to the face value of the Loan. The obligation of Holdco to pay the subscription price to African Holdco under the subscription agreement was discharged by the transfer of the Loan to African Holdco. So, after the third step African Holdco held the Loan in its wholly-owned subsidiary, Foreign Holdco.
- Fourth, African Holdco in turn subscribed for further ordinary shares in the capital of Foreign Holdco for a subscription price equal to the face value of the Loan. The obligation of African Holdco to pay the subscription price to Foreign Holdco under that subscription agreement was discharged by way of set-off against the Loan, resulting in the Loan being extinguished.

It is the fourth step in the restructure that is of interest in the present case. SARS ruled as follows in relation that step, to the extent that it is relevant:

- For purposes of paragraph 20 of the Eighth Schedule of the Income Tax Act, No 58 of 1962, African Holdco acquired the further shares in Foreign Holdco for an expenditure equal to the subscription price of the shares. In other words, SARS accepted that, for capital gains tax purposes, the base cost of the further shares in Foreign Holdco would be an amount equal to the subscription price, that is, an amount equal to the face value of the Loan.
- The set-off of the Loan against African Holdco's obligation to pay the subscription price did not give rise to any capital gain in African Holdco.

As African Holdco was not a tax resident in South Africa, it was not necessary to consider the South African tax effects of the restructure for it. Had it been a South African tax resident, it would have been interesting to see how SARS would have ruled on the tax implications of the extinction of the Loan. The reduction of a debt for inadequate consideration can in certain cases have negative tax consequences for South African tax resident debtors – see the Tax Alert of 15 January 2016.

SARS has never said in so many words that those debt reduction rules would legitimately be avoided if:

- a creditor subscribes for shares in a debtor company for a subscription price equal to the debt; and
- the obligation to pay the subscription price is set off against the obligation to repay the debt.

In a draft Interpretation Note, SARS does say that, in principle, the reduction of debt through the issue of shares ought not to trigger adverse tax consequences. It does appear

as if the Ruling is a further acceptance by SARS that the capitalisation of a loan account by subscription and set-off – as opposed to a settlement for cash – ought not to have a negative tax effect.

Note that a SARS ruling only applies to the persons who requested the ruling. However, SARS's rulings do give taxpayers an idea of its view on matters addressed in the rulings.

SARS ruling on a share subscription transaction followed by a share

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On 17 March 2016, the South African Revenue Service ("**SARS**") issued an interesting binding private ruling ("**BPR 227**") concerning a share subscription transaction which was followed by two share buyback transactions.

BPR 227 deals with an area that National Treasury and SARS have identified as a problem, namely where a shareholder disposes of its shares through means of a share buyback as

opposed to selling the shares outright to a third party. Before dealing with BPR 227 we will explain the background to this issue, the steps taken by National Treasury and SARS to deal with this issue and why BPR 227 was treated differently.

Published SARS rulings are necessarily summaries of the facts and circumstances. Consequently, BPR 227 (and this article discussing it) should be treated with care.

The background

In commercial terms, there is a very important distinction between a subscription for shares and a purchase of shares. When a company raises capital for itself, investors give money (new consideration) directly to the company. In return, the company issues new shares to the investors. A subscription therefore involves the issue of new shares by the company and the proceeds of the subscription go to the company.

At other times, a would-be investor can acquire shares buying previously-issued shares from an existing shareholder, in which case the company will not usually receive anything. A purchase therefore involves the acquisition of shares that have already been issued. The proceeds of the sale belong to the seller of the shares.

The distinction between purchase of existing shares and subscription for an issue of new shares is important for capital gains tax and dividends tax purposes. The example below illustrates this distinction.

Share sale versus share subscription and share buyback

The outgoing shareholder can avoid capital gains tax partially or completely by opting to sell its shares back to the Target Company rather than selling its shares to the incoming shareholder. The tax benefit associated with this approach is illustrated in the table below.

However, it is anticipated that a portion of the share buyback consideration (i.e. at least the subscription price for the shares) would amount to a reduction in contributed tax capital and thus not constitute a dividend.

Budget 2016

Recognising the loss to the fiscus of the share issue-buyback combination, National Treasury included a reference to these transactions deep inside the 2016 budget review document. The budget review elaborates on some of the proposals contained in the Minister of Finance’s budget speech, clarifies certain matters and presents additional technical proposals. The budget review dedicated the following paragraph to this issue:

“**Avoidance schemes in respect of share disposals**

One of the schemes used to avoid the tax consequences of share disposals involves the company buying back the shares from the seller and issuing new shares to the buyer. The seller receives payment in the form of dividends, which may be exempt from normal tax and dividends tax, and the amount paid by the buyer may qualify as contributed tax capital. Such a transaction is, in substance, a share sale that should be subject to tax. **The wide-spread use of these arrangements merits a review to determine if additional countermeasures are required.”** (our emphasis).

The budget review does not explain on what type of “additional countermeasures” will be considered. Thus, these additional countermeasures could seek to remove the dividends tax exemption or possibly amend the way proceeds are calculated for capital gains tax purposes.

Taxpayers will have to wait until the publication of this year’s tax amendment legislation to determine whether the proposed review will result in additional countermeasures. For now, it is opportune to speak briefly about the existing

countermeasures that are in place to deal with these arrangements.

Mandatory disclosure of reportable arrangements

The main purpose of mandatory disclosure rules is to provide early information regarding tax planning schemes and to identify the promoters and users of those schemes. On 16 March 2015, the Commissioner for SARS issued a public notice (“**the 2015 notice**”) setting out a list of reportable arrangements.

If an arrangement is a “reportable arrangement”, full disclosure of the details of the arrangement must be made to SARS. The 2015 notice took effect from 16 March 2015 and replaces all previous notices. The 2015 notice introduced a category of reportable arrangements relating to share buy-backs which are linked to a share subscription. The reportable arrangement reads as follows:

“2.2. An arrangement in terms of which—

(a) a company buys back shares on or after the date of publication of this notice from one or more shareholders for an aggregate amount exceeding R10 million; and

(b) that company issued or is required to issue any shares within 12 months of entering into that arrangement or of the date of any buy-back in terms of that arrangement;”

On 3 February 2016, the Commissioner issued a further notice which replaced, with effect from its date of publication, all previous notices. The 2016 notice repeats the reportable arrangement contained in the 2015 notice.

A basic design principle underpinning mandatory disclosure requirements is that they should be clear and easy to understand in order to provide taxpayers with certainty about what is required by the regime. Lack of clarity and certainty can lead to failure to disclose (and the imposition of

penalties), which may increase resistance to such rules from the business community.

The trigger for the reportable arrangement is if "… a company buys back shares on or after the date of publication of this notice …". Since the 2016 notice replaces the 2015 notice, it means that only share buybacks that occur on or after 3 February 2016 will trigger the reportable arrangement (provided the remaining requirements are met). Thus, a share buyback that took place prior to 3 February 2016 will no longer be reportable under the 2015 notice (as that has been replaced by the 2016 notice) and it will not be reportable under the 2016 notice as the share buyback took place prior to 3 February 2016.

Also, the words "issue any shares within 12 months of entering into that arrangement …" may lead to some uncertainty on whether "within 12 months" means 12 months **before** or 12 months **after** entering into the arrangement (or it means 12 months before and 12 months after). We think it goes both ways. Taxpayers who enter into share buyback arrangements should check whether they issued shares 12 months before or 12 months after the share buyback arrangement.

Substance over form and general anti-avoidance rule

In addition to the mandatory disclosure requirements, SARS may invoke the substance over form doctrine or the general anti-avoidance rule as existing countermeasures against these type of transactions. Much has been written about these provisions and I do not think it necessary to repeat their essential features in this article. Armed with these existing countermeasures, it remains to be seen what National Treasury and SARS has in mind with their "additional" countermeasures.

BPR 227

A binding private ruling is binding advice that sets out how a tax law applies to an applicant taxpayer in relation to a

specific scheme or circumstance. A binding private ruling applies only to the applicant identified in the ruling. As stated, the published ruling only gives the readers a glimpse of the facts and circumstances contained in the applicant's ruling application.

In BPR 227, the applicant was one of three shareholders of co-applicant A, a state-owned company, which was the shareholder of Co-Applicant B. For operational and strategic reasons, the applicant intended to divest from co-applicant A to manage its investment in co-applicant B directly. The parties considered that a share subscription transaction followed by two share repurchase transactions would be the most commercially efficient manner for implementing the applicant's exit, as a shareholder, from co-applicant A.

The proposed transaction will be implemented as follows:

[1] The Applicant will obtain intra-day funding from Bank A.

[2] The Applicant will use the intra-day funding and its own funds to subscribe for equity shares in Co-Applicant B.

[3] Co-Applicant B will use the proceeds received from the Applicant to enter into a share repurchase transaction for a specified number of equity shares held by Co-Applicant A (first share repurchase transaction). The repurchase consideration will be settled in cash and the securities transfer tax paid.

[4] Co-Applicant A will use the proceeds received from Co-Applicant B to enter into a share repurchase transaction for all the shares held by the Applicant (second share repurchase transaction). The repurchase consideration will be settled in cash and the securities transfer tax paid.

[5] The Applicant will use the proceeds received from Co-Applicant A to repay Bank A.Steps [2] and [3] that which

consists of a share subscription followed by a share buyback transactions displays the characteristics of the scheme which the 2016 budget review stated is, in substance, a share sale that should be subject to tax.

The rulings given by SARS in respect of steps [2] and [3] were as follows:

• a portion of the proceeds to be received by co-applicant A for the disposal of the shares in co-applicant B will be deemed to be of a capital nature under section 9C(2) of the Income Tax Act, 1962 ("**ITA 1962**");

• the balance of the proceeds to be received by co-applicant A for the disposal of the shares in co-applicant B will be regarded as a "dividend" as defined in section 1(1) of the ITA 1962 and must be included in the gross income of co-applicant A;

• the dividend to be included in the gross income of co-applicant A will be exempt from normal tax under section 10(1)(k)(i) of the ITA 1962;

• the repurchase of the equity shares held by co-applicant A in co-applicant B in terms of the first share repurchase transaction will be regarded as a disposal of assets by co-applicant A for purposes of the 8th Schedule to the ITA 1962;

• the proceeds for purposes of the 8th Schedule to the ITA 1962 will be reduced by the amount which is regarded to be a dividend and consequently included in the gross income of co-applicant A; and

• no liability for dividends tax will arise in respect of the first share repurchase transaction as co-applicant A is a resident company.

In this transaction, the applicant could have purchased co-applicant A's shares in co-applicant B. Had the applicant done

so, then co-applicant A would probably have derived a capital gain from the disposal to the applicant of its shares in co-applicant B. Instead the applicant subscribed for shares in co-applicant B which used the subscription amount to buyback co-applicant A's shares. As a result, there is no dividends tax liability. A portion of the share buyback consideration amounts to a reduction in contributed tax capital and is thus not a dividend.

The published ruling is frustrating in this respect because it does not explain the commercial rationale why the parties embarked upon a share buyback as opposed to the sale of shares other than stating that the parties considered that a share subscription transaction followed by two share repurchase transactions will be the most commercially efficient manner for implementing the applicant's exit, as a shareholder, from co-applicant A.

What the published ruling does reveal, is that if parties can demonstrate a commercially motivated rationale for the particular sequence of their transactions then it is possible (with SARS' approval) to opt for the share issue – share buyback combination rather than the share sale route.

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[1]Paragraph 35(3)(a) of the 8th Schedule to the ITA 1962 allows the outgoing shareholder to reduce its sale proceeds by any amount that it included in its gross income. The outgoing shareholder will include the dividend (i.e. the share buyback consideration) from the Target Company in its gross income.

[2]Generally, if a dividend is not subject to either normal tax or dividends tax it is likely that paragraph 19 of the 8th Schedule to the ITA 1962 will limit any capital loss on disposal of the shares.