The income tax implications of a return of capital

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In terms of the South African Income Tax Act, 1962 (the **Act**), distributions received by or accrued to a shareholder of a company may constitute either a dividend or a return of capital each of which would give rise to different tax implications for the shareholder or company concerned.

The term dividend, as defined in section 1 of the Act, excludes, *inter alia*, an amount distributed to the extent that the amount results in a reduction of the contributed tax capital of the company making the distribution. A return of capital, as defined in section 1 of the Act, means any amount transferred by a South African tax resident company for the benefit for or on behalf of any person in respect of any share in that company to the extent that that transfer results in a reduction of contributed tax capital of the company (subject to certain exclusions, which are not relevant for present purposes).

Broadly speaking, contributed tax capital is defined, in relation to a class of shares of a company, as the consideration received by or accrued to that company for the issue of shares of that class, reduced by so much of the amount as the company has transferred for the benefit of a shareholder and which has been determined by the directors of the company to reduce the contributed tax capital of the company.

On the basis of the above, it is clear that whether a distribution constitutes a dividend or a return of capital is not dependent on the intention with which the shareholder holds the relevant share (ie whether a shareholder holds a share as a capital or revenue asset would not impact on the nature of any distribution made in respect of such share). As such, for example, it is possible for a person holding a share as a revenue asset to receive or accrue a return of capital or a dividend in respect of such share.

The Act clearly sets out the tax implications arising in respect of a distribution by a company that constitutes a dividend. The tax implications arising in this regard would depend on, *inter alia*, whether the dividend distribution is a cash distribution or a distribution of an asset *in specie*, the nature of the beneficial owner of the dividend (for example, a South African tax resident or exempt entity) and the nature of the share in respect of which the dividend is distributed. Whether the shareholder holds the share in respect of which a dividend is distributed as a capital or revenue asset should, however, generally not impact upon the tax consequences arising from a dividend distribution.

The following provisions of the Eighth Schedule of the Act may be applicable in the event of a shareholder receiving a return of capital in respect of a share held in a South African tax resident company:

- in terms of Paragraph 76B(2), the base cost of the share held by the shareholder should be reduced by the amount of the return of capital received or accrued.
- if the return of capital exceeds the base cost of the share, paragraph 76B(3) provides that the difference between the base cost and the return of capital received will be regarded as a capital gain in determining the aggregate capital gain or aggregate capital loss of the

shareholder for the year of assessment in which that return of capital is received by or accrues to the holder of that share.

The abovementioned provisions of the Eighth Schedule of the Act deal with the capital gains tax implications of a return in capital and should, accordingly, be applicable in circumstances where the shareholder holds the share in respect of which the return of capital is made as a capital asset.

The tax implications that arise in circumstances where a shareholder holds a share as a revenue asset and receives a return of capital in respect of such shares, appear to be less clear. In particular, the Act does not provide for a corresponding income tax provision which would apply should, for example, a share dealer receive a return of capital in respect of a share held as a revenue asset. The Comprehensive Guide to Capital Gains Tax (**CGT**) (Issue 5) provides as follows in this regard (at page 638):

CTC received by or accruing to a share-dealer comprises gross income in that share-dealers hands when the relevant shares are held as trading stock. At the same time a distribution of CTC constitutes a return of capital which can trigger a reduction in base cost under para 76B(2) The receipt of such a return of capital by a share-dealer raises the issue of double taxation

Since there is a necessary implication against double taxation in the Income Tax Act, it is accepted that such amounts must not again be taken into account for CGT purposes, and their treatment as ordinary income will take precedence.

On the basis of the above, in our view, should a share-dealer receive or accrue a return of capital in respect of a share held as a revenue asset, the following tax implications should arise in terms of general South African tax principles:

- the shareholder should reduce the tax cost at which the

relevant share is held by the amount or value of the capital received by or accrued to them.
- to the extent that the return of capital exceeds the tax cost of the relevant share in the hands of the shareholder, such excess should be included in the gross income of such shareholder.

It is apparent, on the basis of the above, that shareholders should carefully consider the South African tax implications arising in respect of dividend distributions and returns of capital received by or accrued to them including returns of capital received by or accrued to persons holding the share in respect of which the distribution is made on revenue account.

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