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DISPOSING OF SHARES IN A COMPANY

2017 DRAFT TAX AMENDMENTS

The 2017 draft taxation amendments were published on 19 July 2017. One of the most important changes were the changes relating to dividends and share buybacks. There have been a number of structures that have abused certain tax provisions with the result that government has now included further anti-avoidance provisions to circumvent the so called dividend stripping opportunities that existed pre the 2017 amendments.

THE AMENDMENTS TO PARAGRAPH 43A AND SECTION 22B ARE INCLUDED AND APPLY ON DISPOSALS ON OR AFTER 19 JULY 2017.

What was the issue?

Share buyback example

Lets assume Company A owns 100% of the equity shares of Company B. Company B is worth R 100m all represented in retained income. Company C would like to purchase Company B for R 100m. Company B would issue shares to Company C for R 100m. The R 100m would then be used by Company B to purchase the shares that Company A owns in Company B resulting 100% of the shares of Company B held by Company C. The benefit with this structure pre the 2017 amendments is that the that R 100m payment to Company A is a dividend which is exempt from income tax (section 10(1)(k)) and is also exempt from dividends tax due to the payment to another resident company (note that the directors would need to state that the share buyback is not a reduction of contributed tax capital). The result is that the R100m has been paid indirectly from Company C to Company A tax free. Important to note that due to the fact that the R100m is a dividend, proceeds for capital gains tax purposes is nil. This would result in a capital loss representing the original investment by Company A in Company B. This loss is disregarded in terms of paragraph 19 of the Eighth Schedule.

Dividend example

Another example that we often see, especially in the B-BBEE environment, is that the value of the company is reduced by means of a dividend and then on the reduced price the shareholders of the company dispose of their shares, or a portion thereof, to the incoming shareholders. Applying this is to the example above and assuming that 50% of the company is being sold to a B-BBEE entity that has cash of R 20m, Company B would declare out a dividend of R 60m reducing value to R 40m and then sell 50% of its shares in Company B to Company C for R 20m. The dividend that is paid to Company A of R 60m is exempt from tax and the proceeds for capital gains tax is only on the value of R 20m.

The proposal

The current anti-dividend stripping rules should be extended to take into account the following:

1. Variations in the share buyback schemes that taxpayers are entering into

to avoid normal tax on income or CGT on the outright sale of shares;

2. The limited scope of application of dividend stripping rules that focus only on debt funding advanced or guaranteed by a prospective buyer; and

3. The limited scope of application of dividend stripping rules.

The implication of falling within paragraph 43A of the Eighth Schedule or Section 22B is that the dividend income which is exempt in terms of Section 10(1)(k) is recharacterized as proceeds for CGT or gross income for Section 22B. The amended rules dealing with dividend stripping will apply in the following circumstances (all three need to be met):

1. The person (being a company) disposing of the shares in another company must be a resident company. The logic is that SARS is trying to block the postponement of tax therefore if declared to a person other than a company dividends tax would have been applicable (i.e. if the shareholder was a trust or a natural person dividends tax would have been paid);
2. That person must hold a qualifying interest in that other company at any time during the period of 18 months prior to that disposal (i.e. at least 50% of the equity shares in that other company or at least 20% of the equity shares in that other company if no other person holds the majority of the equity shares); and
3. An exempt dividend is received by or accrued to that company within a period of 18 months prior to the sale or in respect of or in consequence of that disposal.

The effective date of the above amendments is deemed to come into operation on **19 July 2017** and applies in respect of **any disposal** on or after that date.

Applying the amendments to our scenarios

Share buyback example

The full dividend received of R 100m will be recharacterized to proceeds for CGT proposes due to the following:

1. Company A is disposing of shares in Company B and both companies are residents.

2. Company A owns 100% of the shares in Company B.

3. Company A received a dividend of R 100m within 18 months from the disposal of the shares in Company B. Important to note that its not only the dividend related to the buyback but all dividends that has been received within the last 18 months from the sale of the shares in Company B.

Dividend example

The dividend of R 60m is received within 18 months from the sale resulting in this amount being included to proceeds for CGT purposes. Net proceeds will be the R 20m received from Company C as well as R 60m dividend received.

As can be seen from the above the amendments have a substantial impact of the taxation that is applicable and it is recommend to review all contracts to ensure that the provisions of paragraph 43A and Section 22B are considered carefully.

As noted above the amendments are still in draft.

On 14 September 2017 National Treasury and SARS presented feedback in response to the comments raised on the amendments. The main

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changes with respect to dividend stripping and share buybacks that have been accepted and will be amended are as follows:

1. The 2017 Draft TLAB will be changed to limit the application of the rules to dividends that are considered excessive as compared to a normally acceptable dividend (known as extraordinary dividends) received by a company within 18 months preceding the disposal of a share in another company.

   Any dividends received within 18 months preceding a share disposal in respect of that share that exceed 15 percent of the higher of the market value of the share disposed of (as determined at the beginning of the18 month period and the market value of the shares on the date of disposal) will be treated as extra ordinary dividends and will therefore be subject to the anti-avoidance rules.

2. An exclusion in respect of preference shares will be included with the limitation of extraordinary dividends included as well.

3. The effective date will be changed to ensure that arrangements whose terms were finally agreed to by the parties on or before 19 July 2017 will not be subjected to the new amendments (i.e. contracts concluded before 19 July that were subjected to suspensive conditions are not impacted by these amendments).

4. A distinction will be made in the definition of "qualifying interest" between listed and non-listed entities. A shareholding of 10% will be proposed with regard to listed companies. For non-listed entities the 50% and 20% will remain.

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