Legislative developments: Revision of anti-avoidance rules on share buy-backs and dividend stripping

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In brief

Section 22B of the Income Tax Act, 1962 ("the Act") and paragraph 43A of the Eighth Schedule to the Act contain what is commonly referred to as the "anti-dividend stripping" rules. During the 2017 legislative cycle, certain amendments were made that were aimed at strengthening the rules.

The 2017 amendments did, however, give rise to some problems. The Taxation Laws Amendment Bill, 2018 ("the TLAB, 2018"), introduced in Parliament on 24 October 2018, includes a number of proposed amendments that are aimed at addressing these problems. This Tax Alert gives a broad outline of these proposals.

In detail

A recap: what is "dividend stripping"?

"Dividend stripping" is the practice involving the sale of shares in a "target" company. Ordinarily, if the shares are sold, there will be a gain (that will be subject to tax, whether on revenue or capital account).

In order to avoid this anticipated tax, the target company (before the sale of the shares) pays a dividend to its shareholder. Where the shareholder is a company, the dividend is exempt from dividends tax. As a result of the payment of the dividend, the value of the shares (and therefore the taxable gain on their subsequent disposal) is reduced.

The current rules

Following the 2017 amendments, the rules apply to "extraordinary dividends" that are either paid in the 18-month period prior to the disposal or paid "in respect, by reason or in consequence of" the disposal. An "extraordinary dividend" in relation to a share is the amount of any dividend in respect of that share that exceeds 15 per cent of the higher of (1) the market value of the relevant share at the beginning of the 18-month period; and (2) the market value of the relevant share as at the date of disposal of the share (i.e. at the end of the 18-month period).

In the case of preference shares, the rules provide that where a dividend is determined with reference to a rate of interest, the amount of that dividend that will be regarded as an extraordinary dividend will be the amount of the dividend that exceeds "an amount determined at a rate of 15 per cent".

The corporate reorganisation rules are subject to the anti-dividend stripping rules (i.e. the anti-dividend stripping rules override the corporate reorganisation rules). As per the explanatory memorandum to the 2017 amendments, this was done

"*... in order to ensure that the corporate re-organisation rules are not abused to essentially achieve an outright exemption by taxpayers who strip the value of their shares through dividend stripping and subsequently enter into corporate re-organisations that further benefit from rules that do not recognise* *the disposal or tax consequences of the disposal of shares*".

Concerns with the current rules

The two main concerns with the above rules, which are addressed in the TLAB, are the following:

Firstly, the rule defining what constitutes an "extraordinary dividend" in respect of a preference share is widely regarded as being vague and potentially ambiguous, and therefore difficult to apply. This is because the term "preference share" is not defined for the purposes of the anti-dividend stripping rules (unlike section 8EA of the Act, which deals with dividends on third-party backed shares). Moreover, the reference to "an amount determined at a rate of 15 per cent" is vague and uncertain (it is not clear, for example, what base the 15 per cent must be applied to, e.g. the capital or the subscription proceeds, nor is it clear over what period the 15 per cent is to be determined).

Secondly, the overly simplistic override of the corporate reorganisation rules by the dividend stripping rules is not only affecting legitimate transactions, but also potentially itself creating opportunities for avoidance.

Proposals in the TLAB, 2018

Preference shares

In order to create more certainty around what constitutes an extraordinary dividend in respect of a preference share, it is proposed that, for the purposes of the anti-dividend stripping rules, a preference share will bear the same meaning as it does for the purposes of section 8EA of the Act. In addition, what constitutes an extraordinary dividend in respect of a preference share has been clarified, and is

"*so much of the amount of any dividend received or accrued in respect of that share as exceeds the amount that would have accrued in respect of that share had that amount been determined with reference to the consideration for which that share was issued by applying an interest rate of 15 per cent per annum for the period in respect of which that dividend was received or accrued*".

Interaction between the corporate reorganisation rules and the anti-dividend stripping rules

National Treasury appears to have accepted the principle that the anti-dividend stripping rules should override the corporate reorganisation rules only in circumstances where there is abuse.

The abuse that is of concern invariably arises in the context of complex multi-step transactions, and the proposals to address the abuse are a reflection of this complexity

In a nutshell, it is proposed that the general override of the corporate reorganisation rules be removed. Instead, the anti-dividend stripping rules will override the corporate reorganisation rules only where a company disposes of shares within 18 months after having acquired those shares in terms of a reorganisation transaction (other than an unbundling transaction). Any exempt dividend that is received by or that accrues to a person that is a connected person in relation to that company during the 18 month period preceding the disposal of those shares by that company will, for the purposes of the anti-dividend stripping rules, be treated as having been received by that company during the period during which it held the shares.

The take-away

The amendments to section 22B and paragraph 43A address critical concerns with these provisions. It does, however, remain to be seen whether the amendments dealing with the interaction between the reorganisation rules and the anti-dividend stripping rules adequately address National Treasury's concerns regarding avoidance and, at the same time, do not act as an impediment to legitimate transactions.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

Kyle Mandy
Johannesburg
(011) 797 4977
kyle.mandy@pwc.com

Gert Meiring
Johannesburg
(011) 797 5506
gert.meiring@pwc.com

Charl du Toit
Cape Town
(021) 529 2367
charl.du.toit@pwc.com

Frank Mosupa
Durban
(011) 797 5294
frank.mosupa@pwc.com

Ian Olls
Port Elizabeth
(041) 391 4474
ian.olls@pwc.com

Hesna Rheeder
Bloemfontein
(051) 503 4202
hesna.rheeder@pwc.com