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Corporate reorganisations: the dividend stripping pitfall

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Under South African corporate reorganisation rules, tax consequences are deferred and do not crystalise at the time of the transaction, but a carefully planned restructuring transaction may result in hardship due to subsequent events. A recently proposed amendment illustrates this risk.

Tax relief under the existing corporate reorganisation rules may be neutralised if assets acquired in terms of these rules are disposed of within 18 months.

However, the consequences of a sale of capital assets within that period are often not severe. Other than disposals that result in an equity holding below certain key levels (such as de-grouping) and in the absence of tax losses, the normal tax treatment generally applies to gains or losses on such a disposal, based on the cost that was rolled-over in terms of the corporate rules. The distinguishing feature of a disposal within 18 months, is usually that any capital gain or loss that would have arisen had the asset not been acquired under the corporate rules, is ring-fenced.

The Draft Taxation Laws Amendment Bill, 2018 was recently released for public comment. It proposes amendments to the so-called dividend stripping rules contained in, *inter alia*, paragraph 43A of the Eighth Schedule to the Income Tax Act, 1962. In this context, a sale of shares held on capital account within 18 months of acquiring such shares under the corporate rules, may have far-reaching consequences.

Essentially, these provisions recharacterise certain dividends as income or proceeds from the sale of shares. Currently, where a share is sold and the shareholder earned extraordinary dividends (as defined) on that share, the dividends are treated as part of the sale proceeds if they are causally linked to the sale or were received or accrued within 18 months prior to the sale. Exempt dividends are extraordinary to the extent that, in aggregate, they exceed 15% of the market value of an ordinary share, based on the value when the share is sold or at the beginning of the 18-month period, if higher. A separate formula applies to preference shares. The proposal clarifies that this formula is based on the consideration for which the preference share is issued.

As mentioned, the proposed amendment applies to shares that were acquired in terms of the corporate rules (referred to as a deferral transaction). The proposal increases the pool of exempt dividends that may be recharacterised (to the extent that they cumulatively exceed the 15% threshold) in three ways:

- dividends that fall into the pool are now measured over potentially a longer period;
- dividends derived by persons other than the selling shareholder may be included in the pool; and
- dividends from shares other than the share that is sold may also be included.

"Dividend stripping" period

Currently, the pool of dividends is determined by amounts distributed during the 18-month period prior to a sale. If a deferral transaction occurred during that period, certain dividends declared on relevant shares during the period of 18 months preceding the deferral transaction will also be included.

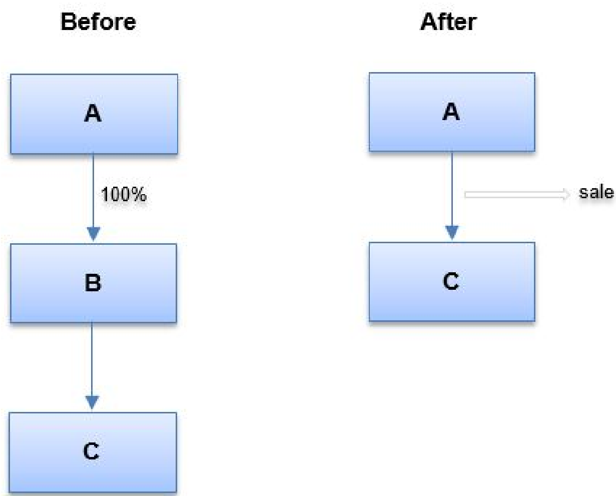
Relevant shares and shareholders

The existing dividend-stripping provisions arguably also apply to disposals of shares under the corporate rules. In terms of the proposal, only an external sale (other than under the corporate rules) will trigger the treatment of dividends as sale proceeds. However, there are new measures that govern the interaction with a deferral transaction.

Where an external sale takes place within 18 months of a deferral transaction, it is not only exempt dividends earned by the seller on the shares that are sold (sale shares) that will form part of the pool of dividends that must be assessed to determine whether the proceeds on disposal of the sale shares will be increased. It is proposed that certain exempt dividends on the following shares or earned by the following persons must also be included:

- shares previously held by the seller (old shares) that were disposed of under a deferral transaction under which the old shares were exchanged for the sale shares or the sale shares were acquired by virtue of holding the old shares. Dividends derived by the seller from the old shares within 18 months prior to the deferral transaction are part of the pool.
- dividends on the sale shares that were earned within 18 months before the deferral transaction by another person who disposed of the shares under a deferral transaction and was connected to the seller at any stage during the preceding 18 months. This could apply to dividends earned by more than one previous owner of the shares where more than one deferral transaction occurred within the 18-month period.

Example: shares acquired by exchange



Consider a group comprising company A with a wholly owned subsidiary B. The only asset of B is a minority equity interest in C. A acquires the shares in C (new shares) from B as a liquidation dividend. This is done under the corporate rules, ie, a deferral transaction. A thus acquires the C shares (new shares) by virtue of holding the B shares (old shares). Within 18 months, A sells the new shares to a third party.

The relevant pool of exempt dividends will be:

- **own dividend income (new shares)**
  - dividends distributed to A on the shares in C during the period that A holds the shares (which is less than 18 months).
- **own dividend income (old shares)**
  - dividends (except a dividend comprising the new shares) distributed to A on the shares in B within 18 months prior to the deferral transaction.
- **connected person dividend income (new shares)**
  - dividends distributed by C to B during the 18-month period prior to the deferral transaction. (B is connected to A and disposed of the shares in C under a deferral transaction.)

Extraordinary dividend: new rule

Currently, the 15% rule mentioned above must be used to determine the extent to which dividends are extraordinary.

The Taxation Laws Amendment Bill, 2018 proposes a more onerous method that applies to shares (new shares) that are acquired under a deferral transaction through exchange for or by virtue of the holding of other shares (old shares) that are disposed under that transaction. The new method must be used if the taxpayer received an exempt dividend:

- in respect of the old shares within 18 months before the deferral transaction; or
- in respect of the new shares and the dividend was derived from a dividend on the old shares that was distributed within 18 months after the deferral transaction to the person who acquired the old shares.

The extraordinary dividend on such a transaction will be the higher of:

- the amount determined by applying the existing 15% rule to the expanded pool of exempt dividends described above; and
- the extraordinary dividend that would have resulted from a hypothetical sale of the old shares to a third party at market value at the time of the deferral transaction.

The effect is that notwithstanding that a company that is sold may be a high value company that allows dividends extracted to remain within the 15% level, a reorganisation transaction within the prior 18 months may still result in an extraordinary dividend which will increase the proceeds upon an external sale of the shares for capital gains tax purposes.

The proposals apply to sales of ordinary shares from 1 January 2019.

Conclusion

If the proposals are enacted, a sale of shares within 18 months after acquiring such shares under the corporate rules could have far-reaching consequences for the seller.

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