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South African Revenue Service
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BY E-MAIL: policycomments@sars.gov.za

Dear SARS

COMMENTS ON THE DRAFT INTERPRETATION NOTE ON EXTRAORDINARY DIVIDENDS TREATED AS INCOME OR PROCEEDS ON THE DISPOSAL OF CERTAIN SHARES

The National Tax Committee, on behalf of the South African Institute of Chartered Accountants (SAICA), welcomes the opportunity to make a submission to the South African Revenue Service (SARS) on the Draft Interpretation Note (IN) that provides guidance on the interpretation and application of section 22B and paragraph 43A relating to the income tax treatment of extraordinary dividends on certain disposals and deemed disposals of shares by a company to prevent so-called “dividend stripping”.

We set out below our comments in this regard.

COMMENTS

General – Application of section 22B and paragraph 43A in the examples

1. In all the examples relating to preference shares, the dividend on preference shares is treated as an “extraordinary dividend” as defined in section 22B(1)/paragraph 43A, under paragraph (a) of that definition and section 22B(2) and paragraph 43A(2) are applied.
2. However, when one considers section 22B(2), which states that where a company holds shares in a company and disposes of those shares and that company held a qualifying interest in that other company at any time during the period of 18 months prior to that disposal, the amount of any exempt dividend received by or accrued to that company in respect of the shares disposed of must, to the extent that the exempt dividend consists of an extraordinary dividend and those shares were held as trading stock, be included in the income of that company.
3. “Qualifying interest” as defined in section 22B(1) means an interest held by a company in another other company, whether alone or together (a) if that other company is not a listed company, at least (i) 50% of the equity shares or voting rights in that other company; or



(ii) 20% of the equity shares or voting rights in that other company if no other person....holds the majority of the equity shares or voting rights in that other company; or
(b) if that other company is a listed company, at least 10 per cent of the equity shares or voting rights in that other company.

4. Thus, the requirement to hold a qualifying interest, requires the company to hold **equity shares or voting rights** in that other company at any time during the period of 18 months prior to that disposal. The same principle applies to paragraph 43A(2).
5. In certain of the examples, the holder of shares factually holds only preference shares and no mention is made of other shares, particularly equity shares. So it would appear that section 22B(2)/paragraph 43A would not apply to these transactions.

6. Submission: The examples should be amended accordingly and/or reference to the requirements of a 'qualifying interest' as explained on page 24 of the Draft IN should be made.

General – Calculation of “extraordinary dividend”

7. The definition of “extraordinary dividend” in section 22B(1) and paragraph 43A(1) in relation to a preference share 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 applying an interest rate of 15 per cent per annum for the period in respect of which that dividend was received or accrued.
8. The courts have held in the Ocean Manufacturing case (Commissioner for Inland Revenue v Ocean Manufacturing Ltd. (483/88) [1990] ZASCA 66; 1990 (3) SA 610 (AD); [1990] 2 All SA 422 (A) (1 June 1990) that 'any' is "a word of wide and un[quali]fied generality. It may be restricted by the subject-matter or the context, but *prima facie* it is unlimited.". Thus, in the context of section 22B and paragraph 43A, these provisions will apply to all the dividends received in respect of a share, but we submit it will apply to each dividend individually and not in aggregate.
9. However, if the intention was that that the 15% reduction should be subtracted from the aggregate of all dividends received or accrued during the 18-month period (or in respect, by reason or in consequence of the disposal) then we submit that the appropriate wording would have been “so much of the aggregate of any dividends received or accrued... as exceeds 15 per cent”. Further weight to this interpretation is the clear difference in wording of the definition of “extraordinary exempt dividends” in para 19 of the Eighth Schedule, which, unlike the wording of paragraph (b) of the definition of “extraordinary dividend”, does refer to the “*aggregate of any exempt dividends received or accrued within the period of 18 months*”.

10. Submission: The reading of the definition of “extraordinary dividend” is problematic and it would be appreciated if SARS could clarify its views in this regard in the IN.

Paragraph 4.1.3 Extraordinary dividends received or accrued on preference shares

11. A “preference share” is defined in s22B(1) and paragraph 43A(1) as a preference share defined in section 8EA(1). Section 8EA(1) in turn defines a preference share as any share (a) other than an equity share; or (b) that is an equity share, if an amount of any dividend or foreign dividend in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money.
12. A share may be a “preference share” simply by virtue of its entitlement to dividends being capped at a certain monetary amount, for example R1 million over an unspecified period of time, that is, the dividend of R1 million is not linked to a time period.
13. Paragraph 4.1.3 stipulates that in relation to a preference share, an extraordinary dividend means –
 - 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 annum for the period in respect of which that dividend was received or accrued.
14. It appears that the extraordinary dividend assumes that a dividend is calculated on a time-based basis, but this is not always the case as explained above, where the R1 million could have been paid in two different years, years apart for instance.
15. Submission: It is unclear how to interpret paragraph (a) of the definition of “extraordinary dividend” in these circumstances and the IN would benefit from an example setting out SARS’ view of the matter.

Example 2 – Extraordinary dividend received/accrued on cumulative redeemable preference shares paid on redemption

16. On page 7, Example 2 deals with an extraordinary dividend received on a cumulative redeemable preference share, where the dividend is paid on redemption. It states that Company A acquired redeemable preference shares on 1 April in “year 1” and these shares were redeemed on 31 March “year 6”.
17. The preamble to the draft IN states that “year 1”, “year 2” etc. in any of the examples refer to the respective calendar year. Thus, the shares were thus held for 5 years.
18. Submission: 1 April “year 1” to 31 March “year 6” gives a period of 5 years in total. Therefore, the complexity in respect of the holding of the shares for a sixth year does not arise, contrary to what the example alleges.



Paragraph 4.1.3 Extraordinary dividends received or accrued on shares other than preference shares (paragraph (b) of the definition of “extraordinary dividend”)

19. On page 10, it is stated that taking the principles from various cases referred to in the Draft IN into account and bearing in mind that section 22B and paragraph 43A are anti-avoidance provisions intended to curb the use of certain share buy-back schemes as well as schemes seeking to circumvent the dividend-stripping rules, the expression “*in respect of*” must be widely interpreted in the context of section 22B and paragraph 43A in the sense of “*in connection with*” and “*in relation to*”.

20. Submission: Because the expression “*in respect of*” is immediately followed by “*by reason or in consequence of*” in (b) of the definition of “extraordinary dividend” which has the effect of broadening the scope of the provision, it is submitted that the expression “*in respect of*” must be interpreted narrowly in context and not widely, since if “*in respect of*” were interpreted broadly it would render nugatory the further expression “*by reason or in consequence of*”.

Example 5 – Extraordinary dividend received/accrued on cumulative participating redeemable preference shares paid on redemption

21. On page 11, Example 5 deals with an extraordinary dividend received on a cumulative participating redeemable preference share, where the dividend is paid on redemption.

22. The example states that, because of the participation right, this is not a preference share but an equity share, and therefore the extraordinary dividend is calculated by reference to the dividends received within 18 months as a percentage of the market value.

23. It should be noted, however, that paragraph 43A defines “preference share” as meaning a “preference share as defined in section 8EA(1)”. That definition refers to a share (a) other than an equity share; or (b) that is an equity share “if the amount of any dividend ... in respect of that share is based on or determined with reference to a specified rate of interest or the time value of money”.

24. It is our understanding that the word “any” here does not mean “all” in relation to the dividends, otherwise the share could never be an equity share. Thus, it is our view that the word “any” in this context means any portion or any single dividend that is payable.

25. Submission: Based on the discussion above, the example should be amended as the shares are indeed preference shares for the purposes of paragraph 43A.

Example 7 – Extraordinary dividend received/accrued “in respect, by reason or in consequence of” the disposal of a share other than a preference share

26. On page 13, Example 7 deals with an extraordinary dividend received/accrued “*in respect, by reason or in consequence of*” the disposal of a share other than a preference share.



27. We acknowledge that SARS does, in the last paragraph, qualify its approach by referring to "*the context of the facts and circumstances of the example*". By implication this means that with other facts the redemption would not be "*in respect of*" the disposal of the equity shares.

28. Submission: While we appreciate that SARS would not wish to give a road map as to how to avoid the "*in respect of*" requirement, nevertheless it would be helpful if an example is given where the "*in respect of*" requirement would not be met.

29. We would also point out that, given that capitalisation shares have no contributed tax capital (CTC), the redemption of the "capital" portion of the preference share would thus be an extraordinary dividend on its own terms, and thus subject to CGT.

30. In addition to the above, the annual dividends might all be extraordinary dividends, and thus subject to CGT. The reason is that paragraph (a) of the definition of "extraordinary dividend" calculates the dividend by multiplying the "consideration for which that share was issued" by an interest rate of 15% per annum. In this case it might be argued that the consideration is zero.

31. The counterargument would be that there is indeed consideration. As was pointed out by the Supreme Court of Appeal in the Labat case (C:SARS v Labat Africa Limited (2011) ZASCA 157), there is a difference between 'consideration' given for an issue of a share and 'expenditure incurred' by a company in issuing its shares. The fact that the ordinary shareholders agreed to have the market value of their ordinary shares reduced to a nominal amount would, we submit, be "consideration for which that [preference] share was issued" as a capitalisation share.

32. Submission: What is consideration in this context should be clarified in the Draft IN.

33. On page 14, the R2 million dividend in respect of the redemption of the preference shares is a dividend "*in relation to*" the preference shares and not the ordinary shares. Therefore, paragraph (a) of the definition of "extraordinary dividend", which deals with dividends specifically in relation to preference shares should have applied at the time the preference shares were redeemed.

34. Submission: The example should be amended and as the result would have been that the R2 million dividend less R0 = R2 million would have constituted an "extraordinary dividend" in relation to the preference shares. To impute a dividend on a preference share that is redeemed to an ordinary share is unwarranted in the context of the provision.



Example 21 – Transferee company disposing of reduced-value shares – Paragraph 43A(3)(a)

35. Submission: The first paragraph of the facts should make it clear that the other person to whom Company A disposed of the shares is not a “connected person” in relation to Company A and that the disposal was at arm’s length.

Example 22 – Transferor of “old shares” disposing of “new shares” acquired under a deferral transaction – Section 22B(3)(b)

36. Submission: The first paragraph of the facts should make it clear that Company A to whom Company B disposed of the shares is not a “connected person” in relation to Company B and that the disposal was at arm’s length.

Paragraph 4.1.3 – Dilution of the effective interest in a target company’s equity shares by issuing shares to another person [section 22B(4) and paragraph 43A(4)]

37. On page 39, the meaning of “effective interest” in equity shares is discussed.

38. It is unclear how to determine an “effective interest” where there are multiple classes of equity shares in issue.

39. Submission: The IN would benefit from an example in this regard.

Example 23 – Dilution of effective interest in a target company by issuing shares to another person – Section 22B(4) and paragraph 43A(4)

40. On page 39, Example 23 sets out to explain the application of the proviso to section 22B(2) and paragraph 43A(2).

41. The proviso states: “Where a company disposes of shares that are treated as having been disposed of previously by that company in terms of subsection (4), the amount of any extraordinary dividend in respect of those shares must be included in the income[proceeds] of that company only to the extent to which it has not previously been taken into account in respect of those shares in terms of this subsection.”

42. Thus the purpose of the proviso is to prevent double taxation, that is, when there is a deemed sale and when there is an actual sale.

43. On page 12 of the 2019 Explanatory Memorandum¹ explaining this proviso states the following:

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<http://www.treasury.gov.za/legislation/acts/2019/Explanatory%20Memorandum%20on%20the%20Taxation%20Laws%20Amendment%20Bill%202019%20-%202021%20Jan%202020.pdf>



“Clarifications regarding the interaction between various provisions

The interaction of the deemed disposal rule and the actual disposal rule.

In order to ensure that the deemed disposal rule and the actual disposal rule in respect of dividend stripping do not both apply in respect of the same dividend, it is provided that where a company disposes of a shares that have previously been treated as having been disposed of under the deemed disposal rule, any amount of an extraordinary dividend should only be treated as income or a capital gain to the extent that has not previously been treated as such”.

44. Based on the above there is a view that the proviso to section 22B(2) and paragraph 43A(2) has no application to the facts in the example, since no portion of the dividend of R1 million was previously taken into account in terms of section 22B(2) or paragraph 43A(2). Thus the proviso was intended to cater for the situation in which an extraordinary dividend is declared, followed by a dilution of the effective interest of a shareholder (i.e. a deemed disposal of shares) and then within 18 months of the extraordinary dividend (or in respect, by reason or in consequence of the deemed disposal) an actual disposal of the shares occurs. Absent the proviso, this scenario may lead to a second inclusion of the same extraordinary dividend.
 45. Another view, and the one that is used in the Draft IN, is that the reference to "any extraordinary dividend" refers to the one arising on sale, while "it" refers to the extraordinary dividend arising on dilution (that also arose under subsection (2)).
 46. Should the latter be the correct view, then the amounts used in Example 23, in relation to the year ended on 28 February year 7 are not all that helpful in explaining the principle. The example states that the extraordinary dividend is R100 000 and the portion thereof attributable to the shares deemed sold previously amounts to R20 000, whereas the deemed capital gain from the previous deemed disposal amounted to R152 100. Therefore, only R80 000 is brought to account as deemed proceeds in the Year 7 sale.
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| <ol style="list-style-type: none">47. <u>Submission</u>: Further clarity on why the latter view is used in the Draft IN should be included in the draft IN.48. If the latter view is correct, it would be preferable if the numbers were changed such that the extraordinary dividend in Year 7 amounted to, say, R800 000. Now the portion of that extraordinary dividend attributable to the 20% would be R160 000, and because this must be reduced by the amount of R152 100 of the deemed capital gain, the extraordinary dividend would be R647 900 [(R160 000 – R152 100) + (80% of R800 000)].49. Furthermore, the third paragraph of the facts should make it clear that Company A has no effective interest in Company C and that the disposal was at arm's length.50. This applies equally to the disposal to Company D in the fourth paragraph of the facts. |
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Conclusion

51. We once again thank SARS for the ongoing opportunity to provide constructive comments in this regard. SAICA continues to believe that a collaborative approach is best suited in seeking solutions to complex challenges and should you wish to clarify any of the above matters please do not hesitate to contact us.

Yours sincerely

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