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Enhanced Dividend Stripping Provisions: Share Subscriptions could now trigger a deemed disposal

The Income Tax Act contains specific anti-avoidance provisions targeting transactions where corporate shareholders attempt to avoid paying income tax or capital gains tax on the sale of shares by extracting value from a target company via tax-free dividends prior to or as part of the disposal of the shares in that company. The Taxation Laws Amendment Bill released on 30 October 2019 extends these 'dividend stripping' provisions to situations where extraordinary dividends are declared on or after 20 February 2019 and are followed by a dilution of a corporate shareholding.

These dividend stripping provisions are set out in section 22B and paragraph 43A of the Eighth Schedule to the Income Tax Act.

The current dividend stripping provisions, as contained in the above sections, have four basic requirements:

— Dividends, local or foreign, received by the shareholder must be exempt from both normal tax and dividend withholding tax. For this reason, the provisions primarily affect corporate shareholders of resident companies;

- The shareholder must hold a ‘qualifying interest’ in the target company. This interest can be held alone or in conjunction with connected persons. The threshold differs between listed companies (10%) and unlisted companies (50% or 20% if no one shareholder holds a majority interest) and can be held at any time during the 18 months prior to the disposal event. Shareholders with a qualifying interest are seen as having an element of control over the company and thus the ability to influence the manner in which their exit is structured.
- The shareholder must have received an extraordinary dividend from the target company.
  - In the context of preference shares this would be the dividend amount in excess of a 15% per annum coupon rate;
  - for ordinary ‘equity’ shares this requires a dividend received or accrued within a period of 18 months prior to disposal of the shares and would be that amount of the dividend in excess of 15% of the market value of the share (calculated on the higher of the value at the beginning of the 18 month period or on disposal date).
- The shareholder must dispose of the shares in the target company within a period of 18 months of receiving the extraordinary dividend pursuant to a transaction which is not a tax roll-over relief transaction (unless a certain exception applies). The dividend and disposal could be structured as two separate events or could be pursuant to a share buy-back or redemption.

Where all four of these elements are met, the dividend stripping provisions include the extraordinary dividend as proceeds on disposal of the share in the hands of the corporate shareholder and tax the amount at either the revenue or capital gains tax rates.

Introduction of deemed disposals

The Taxation Laws Amendment Bill provides for the dividend stripping provisions to be triggered where the effective interest of a shareholder in the ‘equity shares’ of a target company is diluted through the issue of new shares by that target company to a third party. New shares in the form of convertible shares will be regarded as ‘equity shares’.

The requirement that the shareholder must have held a qualifying interest prior to the event as well as the requirements that the shareholder must have received a tax exempt and extraordinary dividend within 18 months prior to the event are retained.

It is thus only in circumstances where a shareholder who has an element of control over a company extracts value via an otherwise tax free equity share dividend and within 18 months thereof dilutes their equity share interest that the deemed disposal provisions will apply.

Where triggered, the shareholder will be deemed to dispose of a percentage of the equity shares held equivalent to the percentage reduction in the shareholder’s effective interest.

Importantly, in calculating the taxable gain on the deemed disposal of the shares, no cost will be allocated to the shares deemed to have been disposed of. Should the shareholder actually dispose of those same shares within 18 months of the extraordinary dividend having been received, the amount of the extraordinary dividend taxed on disposal will be reduced by any amounts already taxed on account of the deemed disposal.

The amendment affects dividends declared on or after 20 February 2019, being the date on which the intention to introduce additional anti-avoidance provisions were announced.

Relief for dividends *in specie*

The Taxation Laws Amendment Bill introduces a further change, effective 30 October 2019, with respect to the definition of ‘extra-ordinary’ dividend. In terms of the change, dividends *in specie* arising from certain tax rollover relief transactions known as unbundling transactions and liquidation transactions will not be regarded as extraordinary dividends.

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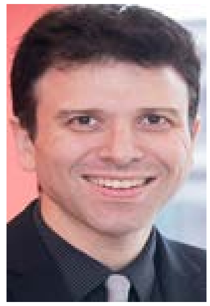

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