Dividend stripping provisions and roll-over relief transactions

For a number of years the Income Tax Act has contained anti-tax avoidance provisions to prevent an activity known as “dividend-stripping”.

Dividend stripping occurs when a resident shareholder in a target company avoids income tax (including Capital Gains Tax (CGT)) arising on the sale of shares in that target company by ensuring that the target company declares an extraordinarily large dividend to that resident shareholder prior to the sale of such shares. In the absence of the dividend stripping rules, this dividend is not only tax exempt but also decreases the value of the shares in the company so that when the shares are disposed of, very little if any proceeds will be received. CGT or income tax that would otherwise have arisen in the shareholder’s hands is reduced or eliminated.

When the dividend-stripping rules apply, the exempt dividend is deemed to be additional proceeds received upon disposing of the shares thereby increasing the taxable gain in the hands of the shareholder.

In 2017, the “dividend stripping” rules in the legislation were strengthened considerably and they now target transactions in which extraordinary dividends are received within 18 months prior to the disposal of the share concerned. These provisions are contained in section 22B and paragraph 43A of the Eighth Schedule to the Income Tax Act.

It was brought to Government’s attention however that these provisions unintentionally affected legitimate transactions where shares are disposed of using roll-over corporate relief. In order to remedy this, the Taxation Laws Amendment Bill, 2019 proposes to amend the dividend-stripping provisions with effect from tax years commencing on or after 1 January 2019.

We set out below the requirements of the current dividend-stripping rules and thereafter we detail the proposed amendments.

The taxpayer must be a company

The dividend stripping rules only apply to taxpayers who are companies for purposes of the Income Tax Act.
Qualifying interest

The dividend stripping provisions require the person disposing of the share to hold a ‘qualifying interest’ in the company declaring the dividend, either at the time of disposal or at any stage within the preceding 18 months. The qualifying interest may be held by the taxpayer alone or together with one or more connected persons. For purposes of section 22B and paragraph 43A, a qualifying interest will be present if:

- In the context of an unlisted company at least 50% of the equity shares and voting rights are held;
- In the context of an unlisted company where there is no majority shareholder, the taxpayer holds at least 20% of the equity shares and voting rights;
- In the context of a listed company, the taxpayer holds at least 10% of the equity shares or voting rights.

Extraordinary dividends

The dividend stripping provisions target extraordinary dividends. These are exempt dividends or exempt foreign dividends received or accrued that are received within 18 months of the disposal of the relevant share or are treated as having been received within that period and which:

- In relation to preference shares are calculated at a rate in excess of 15% (the amount of the dividend in excess of the 15% is considered extraordinary);
- In relation to other shares, exceed 15% of the higher of the market value of the shares as at the start of the 18 month period and as at the date of disposal of the share.

New provisions relating to ‘deferral transactions’

For purposes of the dividend stripping provisions a ‘deferral transaction’ is any transaction in respect of which the roll-over relief provisions were applied. Where shares are disposed of in terms of a deferral transaction that is not a section 46 unbundling transaction, the dividend stripping provisions will not immediately be applicable.

The new legislation contemplates two scenarios where rollover relief is abused and provides that the exclusion from the dividend–stripping rules will not apply to those scenarios.

- Scenario 1 applies where shares are disposed of under a roll-over relief transaction and new shares are not issued as consideration. If:
  - A company (Company A) acquires shares (in Company C) under a roll-over relief transaction and disposes of those shares outside of roll-over relief, within 18 months of the roll-over relief transaction; and
  - The person (Person B) who disposed of the Company C shares under the roll-over relief transaction received exempt dividends in respect of those shares within a period of 18 months prior to the disposal of the shares by Company A; and
  - At any stage during that 18 month Person B was a connected person in relation to Company A; then the exempt dividends received by Person B will be treated as having been accrued to or received by Company A within the period that Company A held the shares. To the extent that the exempt dividends are extraordinary dividends and Company A held a qualifying interest in Company C, Company A will be required to include the amount of those dividends in proceeds on disposal of the Company C shares.

- Scenario 2 applies where a company acquires ‘new shares’ in terms of a roll-over relief transaction in return for or by virtue of the company holding ‘old shares’ that were disposed of under the roll-over relief transaction. If:
  - The company disposes of the new shares outside of a roll-over relief transaction within 18 months of acquiring the new shares; and
Within a period of 18 months prior to the disposal of the new shares, that company had received exempt dividends in respect of the old shares (other than a dividend consisting of the new shares); then

The dividends received on the old shares will be treated as having accrued to or been received by the company in respect of the new shares. To the extent that the dividends are extraordinary dividends and the qualifying interest requirement is met, the amount of dividends received on the old shares must be included in the proceeds on disposal of the new shares.

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