DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

AGREEMENTS ENTERED INTO IN HASTE MAY HAVE RESULTED IN UNDUE FEES AND EXPENSES

In the Budget Speech of 22 February 2012 it was announced that the Capital Gains Tax (CGT) rates would be increased. In particular, it was indicated that the effective CGT rates would be:

- 13,3% in the case of individuals
- 18,6% in the case of companies
- 26,6% in the case of trusts

Effectively, the inclusion rates are to be increased in the case of individuals to 33,3% and in other cases to 66,6%.

Given the fact that the changes were to come into effect for the disposal of assets from 1 March 2012, a number of agreements were concluded with haste on the basis that they were implemented by 29 February 2012. Effectively, the time of disposal of an asset is defined in paragraph 13 of the Eighth Schedule as:

- In the case of an agreement that is subject to a suspensive condition, the date on which the condition is satisfied.
- In the case of an agreement that is not subject to a suspensive condition, the date on which the agreement is concluded.

Parties had to ensure that all suspensive conditions were satisfied by 29 February 2012.

Lo and behold, the Rates and Monetary Amounts and Amendment of Revenue Laws Bill that was released on 13 March 2012 refers to the fact that the increase in the rates is to come into operation on 1 March 2012 "and applies in respect of

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years of assessment commencing on or after that date." In other words, should the year of assessment of a company end on 30 June 2012, it has until such date to enter into transactions at the lower CGT rate. Unfortunately this change in wording does not apply to individuals on the basis that the year of assessment commenced on 1 March 2012. However, companies have now been offered a grace period (and in some instances trusts) on the basis that transactions can still be entered into at the lower CGT rate depending on when the year of assessment ends.

It is a pity that the correct terminology was not used when the change in the tax rates were announced, as it could have saved a lot of anxiety and costs on the part of companies that were in the process of entering into transactions pertaining to the disposal of assets. Those companies that thought that they missed the opportunity can still reconsider this given the change in the wording of the proposed legislation.

Emil Brincker

REDEMPTION OF PREFERENCE SHARES AND THE "CLOGGED-LOSS" RULE

In a recent judgment of the Tax Court (Court), one of the issues for determination was whether the so-called "clogged-loss" rule contained in paragraph 39(1) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) applies to the redemption of preference shares.

In this case, the taxpayer purchased certain redeemable preference shares in B Ltd, a connected person in relation to the taxpayer, from a number of banks. Shortly thereafter, B Ltd redeemed the preference shares for a redemption price that was less than the purchase price paid by the taxpayer for the preference shares. The taxpayer then claimed a capital loss arising out of the redemption.

SARS disallowed the loss on the basis that that the "clogged-loss" rule contained in paragraph 39(1) applied because:

- A redemption of preference shares is a disposal for purposes of the Eighth Schedule to the Act.
- The taxpayer and B Ltd were connected persons.

Paragraph 39(1) provides as follows:

> "*39. Capital losses determined in respect of disposals to certain connected persons*
>
> *(1) A person must, when determining the aggregate capital gain or aggregate capital loss of that person, disregard any capital loss determined in respect of the disposal of an asset to any person:*
>
> *(a) who was a connected person in relation to that person immediately before that disposal; or*
>
> *(b) which is immediately after the disposal:*
>
> *(i) a member of the same group of companies as that person; or*
>
> *(ii) ...*"

In general terms, paragraph 39(1) treats a capital loss determined in respect of the disposal of an asset to a connected person as a "clogged-loss". The capital loss is effectively ring-fenced and can only be set off against gains determined in respect of other disposals (whether in that or any subsequent year) to the same person to whom the disposal giving rise to that loss was made. The person to whom any subsequent disposal is made would still have to qualify as a connected person at that time.

Paragraph 39(1) is essentially an anti-avoidance provision with the aim of preventing a taxpayer from avoiding or reducing its tax liability by creating a capital loss through the disposal of an asset to a connected person. Were it not for the provisions contained in paragraph 39(1), a taxpayer would be able to reduce its tax liability by disposing of an asset (in respect of which the market value has decreased) to a connected person for a capital loss effectively still retaining control of the asset and its benefit.

The taxpayer argued that, while a redemption is a disposal for purposes of the Eighth Schedule to the Act, there is no transfer of the shares from the holder of the shares *to* the redeeming company but rather an extinction of the rights embodied in the shares. If the shares are not transferred *to* the redeeming company then paragraph 39(1) is not applicable.

SARS's view was that the redemption was a kind of "buy-back" constituting a disposal of the shares *to* the redeeming company.

The court, agreeing with the taxpayer, came to the conclusion that the redemption of shares is not a "disposal *to* any other person" as envisaged in paragraph 39(1). The redemption of

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shares, according to the court, results in the extinction of the rights embodied in the shares and not a transfer of the rights to the company redeeming them, or to any other person.

The court accepted that there is a difference between a redemption of shares and a buy-back or repurchase of shares, but on the facts of the case considered it unnecessary to decide the exact nature of the difference.

It is trite that a company cannot hold shares in itself and ultimately in the case of both a redemption and a buy-back, the shares redeemed or bought back are returned to the authorised but unissued share capital of the company. In the case of a so-called "buy-back", an argument may be that the shares vest in the company, albeit momentarily or for a mere split second, before being cancelled and returned to the status of authorised but unissued shares.

The gist of the court's finding is that paragraph 39(1) does not apply to the redemption of shares and thus any loss incurred as a result of the redemption is not ring-fenced. Whilst a redemption does constitute a disposal generally, it is not a disposal to any other person for the purposes of paragraph 39(1). In the result, a taxpayer is allowed to take into account any capital loss determined in respect of the redemption of preference shares held in a connected company when calculating its aggregate capital gain or aggregate capital loss for the year of assessment.

It is uncertain whether SARS intends appealing the finding, but for now it represents another victory for the taxpayer.

Andrew Seaber

DIVIDENDS TAX ON DIVIDENDS *IN SPECIE* PAID TO NON-RESIDENTS

Mr A is tax resident in the United Kingdom (UK). He owns some shares in X Pty Ltd, a private company incorporated and tax resident in South Africa (SA). On 15 April 2012, X Pty Ltd declares and pays a dividend *in specie* to its shareholders, including Mr A.

What are the dividends tax implications?

In terms of s64EA of the Income Tax Act, No 58 of 1962 (Act) the person liable for the dividends tax in respect of an "ordinary" dividend (that is, a dividend that does not constitute a distribution of an asset *in specie*) is the *beneficial owner* of the relevant share (that is, the person entitled to the benefit of the dividend attaching to a share, usually the registered shareholder). However, in terms of that provision, the person liable for the dividends tax in respect of a dividend which consists of a distribution of an *asset in specie* is the *company* that declares and pays the dividend.

In the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2001 – the Bill that introduced many changes to the dividends tax regime – the National Treasury says (at page 38) that "[t]reaty relief is also available for *in specie* dividends…"

That statement is perhaps a bit of an over-simplification.

As noted above, the dividends tax in the case of a dividend *in specie* is a tax on the *company*, and not a tax on the *beneficial owner*. So, as a non-resident shareholder is not liable for the dividends tax in that case, no double tax can arise and one is not able to apply a double taxation treaty. In this respect, the dividends tax in relation to dividends *in specie* is akin to secondary tax on companies, which is also a tax on the company and for which no treaty relief is available.

Section 64FA(2) of the Act says that a company that declares and pays a dividend that consists of a distribution of an asset *in specie* is liable for the dividends tax at a reduced rate if the person to whom the payment is made submits a declaration in the prescribed form to the company "that the portion of the dividend that constitutes a distribution of an asset in specie would, if that portion had not constituted a distribution of an asset *in specie*, have been subject to that reduced rate as a result of the application of an agreement for the avoidance of double taxation…"

Effectively, s64FA(2) says that, for purposes of dividends tax, a dividend *in specie* declared and paid to a shareholder who is not tax resident in SA must be treated as if it were an ordinary dividend which could be reduced by an appropriate treaty.

To return to the example above: X Pty Ltd is liable for the dividends tax in respect of the dividend *in specie* paid to its shareholders. As Mr A is not liable for the tax, he is not able simply by virtue of the UK-SA double taxation treaty to require a reduction of the rate of dividends tax. However, Mr A will be able to fill in the prescribed declaration and require X Pty Ltd to reduce the rate to 10 per cent by virtue of the s64FA(2) read with Article 10 of the SA-UK double taxation treaty.

To sum up, in the case of a dividend *in specie* paid to a non-resident shareholder, the shareholder may be able to reduce the rate of dividends tax not simply by virtue of a double taxation agreement, but rather by virtue of SA domestic law read with a relevant double taxation agreement. A subtle, but perhaps important distinction.

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