DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

OUTSTANDING LOANS TO SHAREHOLDERS AND THE ADVENT OF DIVIDENDS TAX

Companies and their shareholders have been anticipating the changeover from Secondary Tax on Companies (STC) to Dividends Tax for quite some time now, the effective date being 1 April 2012. There are various transitional aspects to consider.

From an administrative point of view, systems need to be in place to deal with the keeping of information relating to the dividend, who it is paid to and who the beneficial owners are. From a commercial perspective, decisions need to be made as to whether it would be cheaper to declare dividends out of retained income before the effective date and pay STC at 10%, or wait until after the effective date and pay Dividends Tax at 15%.

One issue that is often overlooked is loans to shareholders, or their connected persons, on which STC has been paid.

Generally, STC is payable on a loan to a shareholder, or a connected person in relation to that shareholder (s64C(2)(g), unless the loan bears interest at or above the prescribed rate (s64C(4)(d)) or the loan is repaid before the end of the following year of assessment (s64C(4)(f)). The company has to pay STC because the loan is deemed to be a dividend declared (s64C(2)).

When the loan is eventually repaid, the amount repaid is deemed to be a dividend accrued to the company (s64C(5)) and can be set off against dividends declared in the current or next dividend cycle, and so reduce the amount of STC payable by the company (s64B(3)).

The issue that arises in respect of the changeover to Dividends Tax is that, where a company has made such a loan to a shareholder or connected person in relation to a shareholder, and the amount is repaid after the effective date, there is no mechanism whereby the STC paid by the company can be recovered. This is so because the final dividend cycles of all companies will end on 31 March 2012 (definition of "dividend cycle" in s64B(1)) and no set-off can take place in respect of dividends accrued to or declared by a company after that date.

continued

IN THIS ISSUE

Outstanding loans to shareholders and the advent of Dividends Tax

Loans with the option to subscribe for shares

For example, trust X holds shares in company Y, and Z, an individual, is a beneficiary of the trust. Two years ago company Y made an interest-free loan to Z in the amount of R100. Because Z is a connected person in relation to trust X, a shareholder, the loan was deemed to be a dividend and STC of R10 (R100 x 10%) was payable by company X. If Z pays back the loan in full before the effective date, company X will be deemed to have received a dividend and this will reduce company X's future liability for STC in respect of dividends declared (or be added to its STC credit for Dividends Tax purposes (s64J)). However, if Z pays back the loan after the effective date, there is no mechanism under the Dividends Tax regime that reverses the effect of the deemed dividend and the STC paid in respect of that deemed dividend.

The amount of the loan that is repaid after the effective date will not be included in the STC credit of the company for purposes of Dividends Tax as the provisions dealing with a company's STC credit (s64J) does not deal with the accrual of deemed dividends in this context after the effective date.

Effectively then, the company will have paid 10% STC on a loan that is repaid.

Not all shareholders (or persons connected to such shareholders) who have loans outstanding after the effective date will face this problem though. If the shareholder (or person connected to the shareholder) was a company, the deemed dividend declared to it will have been taken into account as a deemed dividend accrued to it and would have reduced its liability for STC. Also, if the shareholder (or connected person) was a listed company, or where the transaction was in any way exempt from the provisions dealing with deemed dividends (s64C(4)), such as where interest on the loan was below the prescribed rate, there would have been no deemed dividend.

However, where the shareholder (or person connected to the shareholder) is a natural person or a trust, and STC was paid by the company on the loan, the parties should consider repayment of the loan before the effective date in order to avoid the problematic situation outlined above.

Heinrich Louw

LOANS WITH THE OPTION TO SUBSCRIBE FOR SHARES

The subject matter of Binding Private Ruling 109 was a loan granted to a borrower with an embedded option to subscribe for shares in the borrower.

The applicant, a company, would raise funds and advance it as a loan to a third-party (unconnected) borrower. The loan would be repaid within three years and the interest payable by the borrower on the loan would be more than the interest payable by the applicant on the raising of the funds.

The borrower would also, as of the day the loan is advanced to the borrower, grant an option to the applicant whereby the applicant could subscribe for shares in the borrower at a future date and at an agreed subscription price. No premium would be payable as consideration for the granting of the option.

The applicant would then sell the option to its holding company (the co-applicant) before the applicant's financial year end.

The interesting feature was that the applicant company and its holding company are both South African residents.

SARS made the following ruling:

- The applicant would be allowed to claim all of the interest incurred by it (under s24J of the Income Tax Act) to raise the funds to be advanced as a loan to the borrower.
- The option granted would constitute part of the amounts receivable under the loan agreement in terms of the definition of "yield to maturity" in s24J(1). Thus the interest accrual to the applicant would be swelled by the granting of the option.
- When the applicant sells the option, the cost of stock in relation thereto would be the market value of the option. Any profit on selling the option to the holding company, being any amounts received over and above the market value, will be taxable.

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- If the option is acquired as a capital asset by the holding company, then the consideration given by the holding company in return would either result in a capital loss for the holding company if the option is not exercised, or it would be added to the base cost of the shares in the hands of the holding company if the option is exercised.

SARS was quite satisfied that no additional amount would be included in the gross income of either the applicant or its holding company if the option is exercised and the value of the shares exceeds the agreed subscription price at the date of exercise.

SARS expressly stipulated that one of the conditions of the ruling is that the applicant should sell the option at market value to its holding company. In the event that the option is sold for less than market value, a portion of the interest allowed as a deduction under s24J(2) as the applicant's cost of finance will be disallowed as a portion of the interest would then have been incurred not in the course of the applicant's trade of advancing the loan, but for its holding company acquiring the option.

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