1 JUNE 2018

TAX & EXCHANGE CONTROL ALERT

IN THIS ISSUE

SECURITIES LENDING ARRANGEMENTS BACK IN THE SPOTLIGHT

Recently the South African Revenue Service (SARS) issued Binding Private Ruling 301 dated 20 April 2018 (Ruling) which determined whether a South African sourced dividend received by a borrower in terms of a securities lending arrangement should be included in the "income" of the borrower and whether any related securities lending expenditure would be deductible.

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The dividend received by or accrued to the Applicant in respect of the SA Equity would be from a source within South Africa and would form part of the "gross income" of the Applicant.

By way of background, in a typical securities lending transaction, equities are lent to a borrower usually to facilitate the borrower to on-deliver or sell such equities within a short space of time. The borrower is then obliged to return the same security (or something similar) to the lender within a stipulated period and to compensate the lender for any distributions (ie dividends) declared on such equities during such period. Ordinarily the borrower also has to put up collateral (often cash) as security for the underlying equities lent. Such arrangements are common in the financial services industry and are entered into for a variety of reasons including for speculating (eg short selling), arbitrage and hedging purposes.

The background facts of the proposed transaction pursuant to the Ruling were similar in that the applicant, a non-resident company (Applicant) would enter into a securities lending arrangement (SLA), in terms of which it would borrow South African equities (SA Equities) from the lender, also a non-resident company (Lender). Importantly, it was assumed that the SA Equities would be borrowed prior to any interim or final dividend on the relevant SA Equity being announced or declared.

The Applicant would then on-deliver (either by way of another securities lending arrangement or collateral arrangement) the SA Equities to independent third-party entities. In anticipation of dividends being declared on the SA Equities, the Applicant would recall the SA Equities prior to the dividend record date which was on average, envisaged to be 20-30 days after the date of on-delivery.

The Applicant, as the owner of the SA Equity on the record date, would receive any dividend paid in respect of the SA Equity. Contractually, the Applicant would be required to pay a "manufactured dividend" to the Lender in terms of the SLA. To the extent that any dividend or interest would be paid on the collateral provided in terms of the SLA, the Lender would make payment to the Applicant of a "manufactured payment" in respect of the collateral. On the close-out date of the SLA, the Lender would return the collateral to the Applicant; and the Applicant would return the SA Equity to the Lender.

SARS made several rulings on the issues at hand including the following:

- The dividend received by or accrued to the Applicant in respect of the SA Equity would be from a source within South Africa as contemplated in s9(2)(a) of the Income Tax Act, No 58 of 1962 (Act) and would form part of the "gross income" of the Applicant under para (k) of the definition of that term in s1(1).

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The key issue is that the taxable income in the hands of the Applicant may be immaterial - the result being that one may then potentially obtain a tax benefit compared to the scenario where the dividend declared would otherwise be subject to 20% dividends tax.

- The dividend would, under para (ff) of the proviso to s10(1)(k)(i) of the Act, not be exempt from income tax on the basis that the dividend would be received by or accrued to the Applicant in respect of a share borrowed by the Applicant. The dividend would accordingly be included in the Applicant's "income", as defined in s1(1).
- The "manufactured dividend", and other related expenditure to be paid to the Lender under the SLA would be deductible by the Applicant in terms of s11(a), read with s23(g) of the Act. The portion of the dividend received by or accrued to the Applicant, remaining after the "manufactured dividend" and after any related expenditure paid to the Lender had been deducted, would be included in the taxable income of the Applicant.

Lastly, on the basis that the dividend would be included in the Applicant's income, such dividend would be exempt from dividends tax in terms of s64F(1)(l) of the Act. Interestingly, while the Ruling expressly stated that the dividend would be from a South African source and included in the Applicant's income, it made no mention or reference to any potential permanent establishment of the Applicant in South Africa or whether the Applicant would qualify for double taxation relief in respect of any double tax treaty.

Furthermore, while SARS generally cannot make any rulings pertaining to the application of the General Anti-Avoidance Rules (GAAR) or the common law anti-avoidance principles, the Ruling specifically stated in paragraph 8 that the proposed transaction was not considered from the perspective of whether it would be entered into with the purpose of avoiding dividends tax. The key issue, in addition to the potential application of any tax treaty, is that the taxable income in the hands of the Applicant may be immaterial - the result being that one may then potentially obtain a tax benefit compared to the scenario where the dividend declared would otherwise be subject to 20% dividends tax.

There are various provisions pertaining to securities lending arrangements in South Africa's tax legislation and, interestingly, the Minister recently announced in the 2018 Budget (Budget Speech) that National Treasury would be introducing further measures to combat certain arrangements which amount to abuse within this area of the law. While the specific transaction identified and mentioned in the Budget Speech does not resemble the facts set out in the Ruling, one should be aware of ongoing developments in this area of tax law.

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