national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

JOINT MEDIA STATEMENT

(NATIONAL TREASURY AND THE SOUTH AFRICAN REVENUE SERVICE)

URGENT: PROPOSED ADDITION TO 2012 TAX LAWS AMENDMENT BILLS TO CLOSE TAX AVOIDANCE SCHEMES RELATED TO THE DIVIDENDS TAX

31 August 2012

I. Background

When significant tax avoidance schemes are identified, the Minister of Finance reserves the right to make an extraordinary announcement and take urgent steps to close-down such loopholes to protect the fiscus. This option is today exercised in relation to tax avoidance schemes related to the Dividends Tax and will take effect on the date of announcement.

The Dividends Tax came into effect on 1 April 2012 at a rate of 15 per cent and is designed to replace the former Secondary Tax on Companies. The Secondary Tax on Companies applied at the company level, leaving the combined company rate above 30 per cent (a rate above the international norm). The Dividends Tax accordingly applies to dividends at the shareholder level so as to avoid this concern. This shift to the shareholder level is in sync with modern international trends.

One consequence of the change is the differing rates applicable depending on the shareholder involved. As a result, dividends paid to pension funds are now exempt. Dividends paid to domestic companies are also generally exempt on the basis that they will be taxed once the profits are eventually paid via further dividends paid to other types of shareholders (e.g. natural persons). Dividends paid to certain foreign shareholders may now be eligible for tax treaty relief.

II. Concerns

A. Dividend schemes involving foreign shareholders

A growing number of advisors are advocating a tax scheme for the benefit of foreign shareholders that arguably reduces the Dividends Tax rate to zero (without any reliance on a tax treaty). These schemes essentially seek to convert the taxable payment of dividends into exempt compensation, gains or income upon disposal. This conversion is arguably accomplished in a number of ways on the alleged basis that the scheme allows for the conversion of Rand denominated dividends into amounts denominated in a foreign currency (even though this conversion could occur through other means). These conversion schemes come in a variety of forms, the most notable of which are described below.

Example 1.
Facts: Listed Company declares dividends to its shareholders. After declaration, but before payment, Foreign Shareholder expects to receive R100 000 of dividends from Listed Company. Foreign Shareholder sells the right to these dividends to Independent South African Company in exchange for a foreign currency equivalent (less a fee). The stated purpose of the transaction is to convert the Rand dividend amount to foreign currency, but the real purpose of the transaction is to eliminate Dividends Tax.

Alleged result: If form fully governs, the sale of dividend rights by Foreign Shareholder is viewed as foreign source income (outside South African taxing jurisdiction). The acquisition of dividends by way of cession is included in the income of Independent South African Company, but the repayment of the equivalent amount (as a manufactured dividend) allegedly qualifies for an offsetting deduction.

Example 2.
Facts: Listed Company declares dividends to its shareholders. After declaration, but before payment, Foreign shareholder expects to receive R800 000 in dividends from Listed Company. Foreign Shareholder sells the shares *cum dividend* to Independent South African Company for $1 million. Foreign Shareholder then repurchases the same shares for $900 000 (after the dividend is paid to Independent South African Company and after subtracting the fee). The stated purpose of the transaction is to convert the Rand dividend amount to foreign currency, but the real purpose of the transaction is to eliminate Dividends Tax.

Alleged result: The sale of the shares by Foreign Shareholder is viewed as foreign source income (outside South African taxing jurisdiction). The receipt of dividends by South African Company after the sale is allegedly viewed as an exempt company-to-company dividend.

Example 3:
Facts: Listed Company declares dividends to its shareholders. After declaration, but before payment, Foreign shareholder expects to receive R800 000 in dividends from Listed Company. Foreign Shareholder lends the shares (including the implicit dividend expectation) to Independent South African Company. During the lending period, Independent South African Company receives R800 000 of dividends on the borrowed shares but must repay the corresponding foreign currency equivalent to Foreign Shareholder (less a fee). This repayment is in the form of manufactured dividends. The stated purpose of the transaction is to convert the Rand dividend amount to foreign currency, but the real purpose of the transaction is to eliminate Dividends Tax.

Alleged result: The share loan by Foreign Shareholder is either viewed as a non-taxable loan or as a foreign source disposition (outside South African taxing jurisdiction). The receipt of dividends by South African Company is included in the income of South African Company but the repayment of the amount (as a manufactured dividend) allegedly qualifies for an offsetting deduction.

Example 4

Facts: Foreign Person is seeking to acquire Listed Company shares without being subject to the Dividends Tax in respect of those shares. In order to achieve this result, Independent South African Company issues a derivative (e.g. a stock future or a contract for difference) that provides Foreign Person with the same yield as Listed Company Shares. Independent South African Company acquires an equivalent number of Listed Company shares as a hedge in relation to the derivative. Listed Company subsequently declares and pays a dividend amounting to R100 000 in respect of the shares held by Independent South African Company.

Result: The gain or loss by Foreign Person in respect of the derivative is viewed as foreign source income (outside South African taxing jurisdiction); including any amount determined with reference to the R100 000 dividend. Independent South African Company will be exempt upon the initial receipt of the R100 000 dividend and arguably qualifies for a deduction in respect of payments to Foreign Person pursuant to the derivative obligation.

B. STC credit schemes

As a transitional measure, taxpayers with STC credits under the pre-existing Secondary Tax on Companies can carry these credits into the new Dividends Tax for a three year period. STC credits are premised on the notion that profits in the form of dividends were once subject to the STC. As stated in the explanatory memorandum associated with the legislation, STC credits are designed so that the same profits are not subject to tax again if passed along via further dividends. That said, National Treasury has expressed longstanding concerns that the mixing of old and new systems could give rise to unintended losses to the fiscus but proceeded with a limited transition rule at the strong insistence of the private sector.

Unfortunately, a small group of aggressive taxpayers have sought to exploit alleged defects in the transitional rules with the purpose of generating STC credits even though no STC was ever paid on the underlying profits. The basic essence of the scheme was to pay exempt dividends between group members during the last dividend cycle before the 1 April effective date of the new Dividends Tax so as to generate STC credits. This creation of STC credits in respect of profits never previously subject to the Secondary Tax on Companies is in clear violation of basic tax principles and in clear violation of the stated intention of the proposed relief. Most tax advisors accordingly advised against entering into schemes of this nature with the exception of an aggressive few.

III. Proposal

A. Closure of dividend schemes involving foreign shareholders

Given the above, schemes involving the conversion of dividends into other forms of non-taxed income will be closed with immediate effect (i.e. from the date that this media statement is released). More specifically, the anti-avoidance rules will apply to eliminate the benefit of the dividend conversion schemes outlined above.

In essence, if a domestic company receives a dividend by way of cession after declaration, the domestic company will be viewed as making a dividend in specie in respect of the consideration issued therefor. If a domestic company acquires the share by way of loan and pays a manufactured dividend in respect of dividends arising from that share loan, the manufactured dividend will be treated as a dividend in specie. If a domestic company acquires a share after a dividend declaration and resells that share to the seller (or a connected person thereto), the domestic company will be treated as having made a dividend in specie to the extent that the purchase price represents compensation for the dividend declared. Lastly, any amount paid by a domestic company pursuant to a share derivative (e.g. a share future and contract-for-difference) will be treated as a dividend in specie to the extent the amount is determined with reference to a dividend declared.

As a result, the domestic company paying these amounts will be subject to the Dividends Tax in respect of these compensating amounts. The exact wording of this anti-avoidance legislation is attached for comment (see **Annexure A**).

Example 1:
Facts: Listed Company declares dividends to its shareholders. After declaration, but before payment, Foreign shareholder expects to receive R100 000 of dividends from Listed Company. Foreign Shareholder sells the right to these dividends by way of cession to Independent South African Company in exchange for a foreign currency equivalent.

Proposed result: Independent South African Company remains exempt from the Dividends Tax in respect of the actual dividends (as an exempt company-to-company dividend). For purposes of the normal tax, the dividends received are included in income but the payment of the foreign currency equivalent is potentially deductible. However, the payment of the foreign currency equivalent will now be viewed as a dividend *in specie* for purposes of the Dividends Tax. Independent South African Company is accordingly subject to the Dividends Tax (with possible relief should the scope of a tax treaty cover the payment).

Example 2:
Facts: Foreign Person enters into a contract-for-difference with Independent South African Company with the value of that contract based solely on the value of a share of Listed Company including dividends arising in respect of those shares. Independent South African Company acquires Listed Company shares in order to fully hedge the contract-for-difference.

Proposed result: Any payment by Independent South African Company in respect of the contract-for-difference will be treated as a dividend *in specie* for purposes of the Dividends Tax. Independent South African Company to the extent the payment is determined with direct or indirect reference to a dividend. This payment is accordingly subject to the Dividends Tax (with possible relief should the scope of a tax treaty cover the transaction).

B. STC credit schemes

When the STC credit was proposed, the stated intention was to provide taxpayers with a starting STC credit as of 1 April 2012 equal to the STC credit equivalent that would have existed on 1 April 2012 had the Secondary Tax on Companies remained in effect. This starting STC credit was designed to equal: (i) the dividends accrued during the last dividend cycle before that 1 April 2012 date, plus (ii) excess accrued dividends from prior cycles, less (iii) dividends declared. These rules were intended to work *in tandem* with the pre-existing STC credit system, which essentially operated on the same basis. Under that system, "no regard" was to be had for dividends accrued in respect of dividends not subject to the Secondary Tax on Companies (see the definitions of "dividend cycle" in sections 64B(1) and 64D read in context with section 64B(3A)).

It has accordingly been proposed that the STC transitional rules be more closely linked to the old system to make absolutely clear that STC credits cannot arise from dividends never previously subject to the Secondary Tax on Companies. The revised language in this regard has already been included in the draft bill released as of 5 July 2012. In addition, the draft legislation will be revised so that the company paying a dividend with overstated STC credits becomes liable for any tax shortfall. As a practical matter, this liability must fall on the paying company because only the company paying the dividend has control over these calculations. Regulated intermediaries and the ultimate shareholders should not be subject to any Dividends Tax liability because these parties merely relied on STC credit relief as alleged by the company payor. All of these changes take effect as of 1 April 2012 (like all other technical corrections proposed in relation to the Dividends Tax).

IV. Public Comments

In view of this urgent addition to the 2012 Draft Taxation Laws Amendment Bills to close tax avoidance measures relating to dividend conversion schemes, the National Treasury and SARS formally request public comments in respect of the above-mentioned proposals, including the revisions to the above-mentioned proposals addressing the misuse of STC transitional credits. Comments should be sent by email to nomfanelo.mpotulo@treasury.gov.za or by fax to (012) 315 5516. Please ensure that these comments reach the National Treasury by 7 September 2012.