



REPUBLIC OF SOUTH AFRICA

EXPLANATORY MEMORANDUM

ON THE

DRAFT TAXATION LAWS AMENDMENT BILL, 2019

(INITIAL BATCH)

10 June 2019

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1. INCOME TAX: INDIVIDUALS, SAVINGS AND EMPLOYMENT

1.1 ALIGNING THE EFFECTIVE DATE OF TAX NEUTRAL TRANSFERS BETWEEN RETIREMENT FUNDS WITH THE EFFECTIVE DATE OF ALL RETIREMENT REFORMS

[Applicable provisions: Paragraph 6(1)(a) of the Second Schedule to the Income Tax ('the Act')]

I. Background

In 2013, retirement fund reform amendments were effected to the Income Tax Act regarding the annuitisation requirements for provident funds. The main objective of these amendments was to enhance preservation of retirement fund interests during retirement and to have uniform tax treatment across the various retirement funds, thus resulting in provident funds being treated similar to pension and retirement annuity funds with regard to the requirement to annuitise retirement benefits. These retirement fund reform amendments were supposed to come into effect on 1 March 2015.

However, when Parliament was passing legislative changes to these amendments, Parliament postponed the effective date for the annuitisation requirements for provident funds until 1 March 2016. During the 2016 legislative cycle, Parliament again postponed the effective date until 1 March 2019. Further, during the 2018 legislative cycle, Parliament once more postponed the effective date to 1 March 2021. These postponements were due to continuing negotiations within NEDLAC.

II. Reasons for change

Each postponement of the effective date requires several consequential amendments to various provisions of the Income Tax Act. In making changes to the effective dates in relation to the several consequential amendments required, but were inadvertently left out in paragraph 6(1)(a) of the Second Schedule to the Income Tax Act, which makes provision for tax neutral transfers between retirement funds. Failure to change the effective date in the above-mentioned provision resulted in the non-taxable treatment of transfers from pension funds to provident or provident preservation funds with effect from 1 March 2019.

The earlier effective date of 1 March 2019 for the tax neutral transfers from pension to provident or provident preservation funds creates a loophole as the intention was to align the effective date of the tax neutral transfers from pension to provident or provident preservation funds with the effective date of retirement reform amendments, which is 1 March 2021.

III. Proposal

In order to include the consequential amendment that was inadvertently left out, it is proposed that changes be made in the Income Tax Act to align the effective date of the tax neutral transfers from pension to provident or provident preservation funds with the effective date of retirement reform amendments, which is 1 March 2021.

IV. Effective date

The proposed amendments are deemed to have come into operation on 1 March 2019.

2. INCOME TAX: BUSINESS (GENERAL)

2.1 CLARIFICATION OF THE INTERACTION BETWEEN THE ANTI-AVOIDANCE RULES DEALING WITH DIVIDEND STRIPPING AND CORPORATE RE-ORGANISATION RULES

[Applicable provisions: Paragraph 12A and paragraph 43A of the Eighth Schedule to the Act]

I. Background

The anti-avoidance rules dealing with dividend stripping were first introduced in the Income Tax Act (the Act) in 2009. Dividend stripping normally occurs when a shareholder company that intends to disinvest in a target company avoids income tax (including capital gains tax) that would ordinarily arise on the sale of shares. This is achieved by the shareholder company ensuring that the target company declares a large dividend to it prior to the sale of shares in that target company to a prospective purchaser. This pre-sale dividend, which is exempt from Dividends Tax (in the case of a resident dividend that declares and pays a dividend to another resident company), decreases the value of shares in the target company. As a result, the shareholder company can sell the shares at a lower amount, thereby avoiding a much larger capital gains tax burden in respect of sale of shares.

In 2017, amendments were made in the Act in order to strengthen the anti-avoidance rules dealing with dividend stripping. According to the 2017 changes, exempt dividends that are regarded as extra-ordinary dividends, received by a shareholder company are treated as proceeds or income subject to tax in the hands of that shareholder company, provided that the shares in respect of which extra-ordinary dividends are received, are disposed of within a period of 18 months prior to that disposal.

Further, in 2018, amendments that were made in 2017 making provision for the anti-avoidance rules dealing with dividend stripping rules to override corporate re-organisation rules were reversed to ensure that these 2017 amendments do not hinder legitimate re-organisation transactions.

II. Reasons for change

It has come to Government's attention that certain taxpayers have embarked on abusive tax schemes aimed at circumventing the current anti-avoidance rules dealing with dividend stripping arrangements. These schemes involve millions of rands and have a potential of eroding the South African tax base. These latest schemes involve, for example, a substantial dividend distribution by the target company to its shareholder company combined with the issuance, by that target company, of its shares to a third party or third parties. The ultimate result is a dilution of the shareholder company's effective interest in the shares of the target company that does not involve a disposal of those shares by the shareholder company. The shareholder company ends up, after the implementation of this arrangement, with a negligible effective interest in the shares of the target company without triggering the current anti-avoidance rules. This is because the current anti-avoidance rules are triggered when there is a disposal of shares while these new structures

do not result in an ultimate disposal of the shares but a dilution of the effective interest in the target company.

III. Proposal

It was proposed in Annexure C of the 2019 Budget Review that amendments should be made to the current anti-avoidance rules to curb the use of these new dividend stripping arrangements. Furthermore, given the abusive nature of these arrangements, it was proposed that the amendments should come into effect from the date of the announcement, which was on the 2019 Annual National Budget Day, (i.e. 20 February 2019). This means that the proposed amendments to the legislation on anti-avoidance rules dealing with dividend stripping will come into effect from 20 February 2019 and apply to dividend stripping schemes entered into on or after 20 February 2019. These legislative interventions will not apply in respect of dividend stripping schemes entered into before 20 February 2019.

In terms of the proposed amendments the anti-avoidance dealing with dividend stripping rules will operate as follows:

- The anti-avoidance rules will no longer apply only at the time when a shareholder company disposes of shares in a target company.

In addition, the new anti-avoidance rules will apply to the following anti-avoidance transactions:

- Shareholder companies will, for purposes of the anti-avoidance rules dealing with dividend stripping, be deemed to have disposed of and immediately reacquired its shares in the target company despite them not disposing of their shares, if the target company issues shares to another party and the market value of the shares held by the shareholder company in the target company is reduced by reason of the shares issued by the target company.
- In such an instance, the shareholder company will be deemed as having disposed of a percentage of the shares it holds in the target company immediately after a share issue that results in a decrease in the value of the shares it holds. The percentage envisaged is the percentage by which the market value of those shares has been reduced by as a result of the issuance of shares.

As with the current anti-avoidance provisions, the amount to be re-characterised will be so much of the tax exempt dividends that were received by or accrued to the shareholder company within 18 months of the deemed that exceed 15 per cent of the higher of the market value of the shares in the target company at the beginning of such 18-month period or market value of the shares held by the shareholder company in the target company.

IV. Effective date

The proposed amendments will be deemed to have come into operation on 20 February 2019 and apply in respect of shares held by a company in another company if the market value of those shares is reduced by reason of shares issued by that other company, on or after 20 February 2019 to a person other than that company.