REPUBLIC OF SOUTH AFRICA

SOUTH AFRICAN REVENUE SERVICE

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STAMP DUTY, INCOME TAX, SECONDARY TAX ON COMPANIES, TAX ON RETIREMENT FUNDS, VALUE-ADDED TAX AND UNCERTIFICATED SECURITIES TAX IMPLICATIONS OF LENDING ARRANGEMENTS IN RESPECT OF MARKETABLE SECURITIES

ISSUED BY THE

COMMISSIONER FOR THE SOUTH AFRICAN REVENUE SERVICE

1 INTRODUCTION

In drawing up standards for clearance and settlement procedures an international working committee found that the settlement status in South African equity markets differed from the settlement status adopted by most countries internationally. The committee recommended that securities lending be encouraged as a method of expediting the settlement of security transactions. Securities lending also improves liquidity, encourages investment and increases pricing efficiency.

Consequently, in 1996 certain amendments were effected to the Stamp Duties Act, No 77 of 1968 (the SD Act) and Income Tax Act, No 58 of 1962 (the IT Act), to introduce the concept of a lending arrangement. The amendments to the IT Act are based on the principles contained in the tax systems of various other countries, such as Australia, Canada, Japan, the United Kingdom and the United States. According to those tax systems the lender of the loaned securities is deemed still to be the owner thereof and no gain or loss arises in the hands of the lender or borrower as a result of the transfer of the loaned securities between the lender and borrower. Payments made in respect of such securities will, however, have certain tax implications.

The provisions of this Practice Note are applicable to residents and non-residents who are subject to the taxes imposed in terms of the various Acts addressed in this Practice Note.

2 STAMP DUTY

Section 23 (1) of the SD Act defines a "lending arrangement" as-:

" any arrangement or agreement in terms of which-

(a) a person (hereinafter referred to as the lender), lends a marketable security to another person (hereinafter referred to as the borrower), in order to enable the borrower to effect delivery of the marketable security under a transaction entered into by the borrower to sell the marketable security; and

(b) the borrower in return undertakes to transfer a marketable security of the same kind and of the same or equivalent quantity and quality to the lender within a period of twelve months from the date of such loan."

Research has shown that a number of countries which levy a duty on share transfers exempt transfers from the duty if the transfer is effected in terms of a lending arrangement. In line with international practice, an appropriate exemption was inserted in the SD Act. Exemption (nB) of Item 15 of Schedule 1 to the SD Act accordingly exempts from stamp duty-:

"Any registration of transfer of any marketable security in the name of the lender of a marketable security, if such registration of transfer is effected in consequence of the return to that lender of a marketable security previously lent to the borrower in question in terms of a lending arrangement."

The exemption applies **only** in the following circumstances:

(a) If the **purpose** of the borrower of the securities is to **enable the borrower to deliver such securities under a transaction** entered into by the borrower to sell such securities. If the borrower has **any other purpose** e.g. to deliver the borrowed securities in terms of another lending arrangement, **the stamp duty exemption does not apply.**

(b) The borrower **must undertake** to return marketable securities of the same kind and of the same or equivalent quantity and quality to the lender within a period of 12 months from the date of the loan (prior to 29 June 1998 this period was 6 months).

In terms of the definition the following agreements will, for example, not qualify for the exemption:

(i) loans for **a period exceeding 12 months**;

(ii) loans, outstanding for a period exceeding 6 months, prior to 29 June 1998; and

(iii) agreements in terms of which the 12-month period **is rolled over** (extended for a further period).

The words "… **the borrower in return undertakes to transfer** …" appearing in the definition of a lending arrangement, read together with the wording of paragraph (nB) of the exemptions to Item 15 (3) are interpreted to mean that the marketable securities must, prior to expiry of the period, be reregistered in the lender's name before the exemption is applicable.

To qualify for the exemption the **borrower or his agent** must certify that the registration of transfer is due to the fact that a marketable security previously loaned to the borrower in terms of a lending arrangement, as defined, was returned to the lender.

3 INCOME TAX

3.1 Manufactured interest

Securities lending arrangements in respect of interest-bearing instruments normally provide that the borrower will compensate the lender for any coupon or other interest received by the borrower who is the registered owner of the interest-bearing instrument during the term of the lending arrangement. The “manufactured interest” is specifically provided for in the definition of “interest” in section 24J(1) of the IT Act and is, therefore, to be treated as such for the purposes of section 24J. This provision will apply, irrespective of whether the lending arrangement is entered into for a period of less than 12 months, or not.

If all the requirements of section 10(1)*(h*A*)* of the IT Act are met, the “manufactured interest” contemplated in the definition of “interest” in section 24J(1) may be exempted in the hands of the recipient who is a non-resident.

3.2 Manufactured dividends

Securities lending arrangements also normally provide that the borrower shall pay to the lender a "manufactured dividend" in lieu of any dividends declared in respect of the security borrowed from the lender. The "manufactured dividend" may include adjustments for the effects of Income Tax or Secondary Tax on Companies (STC). Any payment made by the borrower to the lender as a "manufactured dividend" is not a dividend for Income Tax purposes and must not be treated as a dividend by either the lender or the borrower. The "manufactured dividend" will constitute gross income in the hands of the lender and will not qualify for the exemption in terms of section 10(1)*(k)*. The person who is responsible for the payment of a "manufactured dividend" will only be allowed a deduction in the determination of his taxable income of the amount paid, if the amount meets the requirements of section 11*(a)* of the IT Act.

3.3 Secondary Tax on Companies

The lender may not reduce the amount on which its liability for STC is calculated by the "manufactured dividend" received. The borrower will, therefore, not be liable for the payment of STC on the "manufactured dividend" paid to the lender.

3.4 Trading stock

Although the lender of marketable securities which constitute trading stock in his or her hands, is not the registered owner of the marketable security loaned to the borrower in terms of a lending arrangement, the lender is, in substance, the owner of a marketable security of the same kind, quantity and quality as the marketable security loaned to the borrower.

In terms of section 22(4A) of the IT Act the marketable security which has been loaned in terms of a lending arrangement, as defined, is therefore, for the purposes of section 22(4), deemed not to have been acquired by the borrower thereof. The marketable security which is returned to the lender by the borrower within the period of 12 months, as replacement for the marketable security loaned, is deemed not to have been acquired by the lender for the purposes of section 22(4).

Section 22(9) of the IT Act deems the marketable security, which has been loaned by the lender and has not been returned by the borrower at year-end, to remain closing stock in the hands of the lender. Such marketable security is also excluded from the closing stock of the borrower if he or she is in possession of such a marketable security at his or her year-end.

Where a marketable security loaned does not comply with the requirements of a "lending arrangement", as defined in the SD Act, the provisions of sections 22(4A) and 22(9) will not be applicable.

3.5 Listed shares

For the purposes of section 9B of the IT Act, a share loaned in terms of a lending arrangement is deemed not to be a disposal in the hands of the lender and the share loaned and any replacement share will be regarded as one and the same share in the hands of the lender. Where a lender lends shares to a specific borrower and the marketable securities are not re-registered in the lender's name prior to expiry of the 12-month period, the loan of the shares will not constitute a lending arrangement. The lender will, for purposes of section 9B, have disposed of his shares on the date the shares were transferred to the borrower in terms of the arrangement.

3.6 Repurchase and resale agreements

The definition of “instrument” in section 24J (1) of the IT Act includes repurchase and resale agreements. In essence these agreements provide for the disposal of an asset by a person to another person, at a consideration and subject to an undertaking that the other person will, at a future date, resell the asset or a similar asset to the person who first disposed of the asset. These agreements do not qualify as lending arrangements, as defined in the SD Act and must, therefore, for Income Tax and Stamp Duty purposes, be treated as a sale of and transfer of ownership in the asset between the parties to the agreement.

Any “manufactured dividend” or “manufactured interest” which is payable or receivable or which forms part of the consideration in respect of a repurchase or resale agreement will be taken into account in determining the amount of interest to be incurred or accrued in terms of section 24J of the IT Act, in respect of the relevant agreement.

4 TAX ON RETIREMENT FUNDS

The Tax on Retirement Funds Act, No 38 of 1996, defines “rental income” to include, *inter alia*, any consideration payable by a borrower to a lender, in respect of any lending arrangement as consideration for the use of the marketable security in so far as such amount is not included in the definition of interest in section 24J of the IT Act. Therefore, the fee in respect of the lending of interest-bearing marketable securities, as well as the lending of marketable securities which are equity, will constitute “rental income”, as defined.

As the “manufactured interest” is included in the definition of “interest”, as contemplated in section 24J of the IT Act, such amounts are also subject to the Tax on Retirement Funds.

A “manufactured dividend” in respect of a “lending arrangement” does not constitute “interest” or “rental” as defined in the Tax on Retirement Funds Act.

5 VALUE-ADDED TAX

In terms of the Value-Added Tax Act, No 89 of 1991 (VAT Act), the supply of goods or services by a vendor in the course or furtherance of any enterprise carried on by him is subject to VAT at the standard rate, unless the supply is specifically exempt or subject to VAT at the zero rate.

Section 12*(a)* of the VAT Act exempts from tax the supply of any financial services, as defined in section 2 of the VAT Act, except where such services are subject to the zero rate, e.g. certain supplies of services to non-residents.

As regards scrip lending, the following provisions of section 2 are applicable:

> *“**Financial services**. - (1). For the purpose of this Act, the following activities shall be deemed to be financial services:*

(a) …..
(b) …..

(c) The issue, allotment, drawing, acceptance, endorsement or transfer of ownership of a debt security;

(d) the issue, allotment or transfer of ownership of an equity security;

(e) …..

(f) the provision by any person of credit under an agreement by which money or money's worth is provided by that person to any other person who agrees to pay in the future a sum or sums exceeding in aggregate the amount of such money or money's worth;

(g) - (l):

Provided that the activities contemplated in paragraphs (a), (b), (c), (d) and (f) shall not be deemed to be financial services to the extent that the consideration payable in respect thereof is any fee, commission merchant's discount or similar charge, excluding any discounting cost."

A fee or commission charged by a vendor for making scrip available to another person, is, in view of the proviso to section 2(1), not consideration for a financial service and is, accordingly, subject to VAT.

The view is, however, held that a "manufactured dividend" or "manufactured interest" constitutes consideration for the supply of a financial service, as envisaged in section 2(1)*(c)*, *(d)* and *(f)*, and does not constitute a fee, commission or similar consideration, as envisaged in the proviso. Such consideration is therefore in respect of the supply of a financial service which is exempt from VAT in terms of section 12*(a)* of the VAT Act.

If a single amount is payable to a lender and such amount constitutes both a fee or commission and a “manufactured dividend” or “manufactured interest”, it is essential that, for purposes of section 10(22) of the VAT Act, the amounts attributable to the fee or commission and that attributable to the “manufactured dividend” or “manufactured interest” be indicated at the time the agreement is entered into. Failing a split into the separate elements, the full amount will be subject to VAT.

6 UNCERTIFICATED SECURITIES TAX ACT, NO 31 of 1998 (UST Act)

The UST Act will come into operation on a date to be determined by the President by proclamation in the Gazette. The purpose of imposing this tax is to provide for the dematerialisation of securities listed on the JSE in a Central Securities Depository (CSD).

In terms thereof all share certificates which are deposited in the CSD will be cancelled and shareholding will be represented by entries in the accounts maintained by participants who act on behalf of the shareholders. From a tax point of view it was necessary to introduce a duty on the transfer of uncertificated securities, as the issue of securities and the transfer of beneficial and legal ownership thereof will occur without the filing of any paper.

“beneficial ownership”, is defined in the UST Act as-:
” in relation to a security, includes any one or more of the following:

(a) the right or entitlement to receive any dividend or interest payable in respect of that security; or

(b) the right to exercise or cause to be exercised in the ordinary course of events, any or all of the voting, conversion, redemption or other rights attaching to such security.”.

In terms of section 6(1)*(b)*(iv) of the UST Act an exemption will apply to a change in beneficial ownership in securities in relation to lending arrangements:

"if the change in beneficial ownership is from a lender to a borrower, or *vice versa,* in terms of a lending arrangement and the lender or borrower, as the case may be, who has acquired beneficial ownership has certified to the participant that the change is in terms of such a lending arrangement".

7 CONCLUSION

It has come to the attention of this Office that practices have developed whereby instruments are, for example, endorsed as exempt from stamp duty, in circumstances where not all the elements of a lending arrangement as contemplated in terms of the SD Act are present. The purpose of this Practice Note is therefore to provide taxpayers with clear guidelines regarding the tax consequences of lending arrangements.

Persons who are responsible for the endorsement of these types of instruments must, therefore, ensure that all the relevant requirements have been met, in order to qualify for the relief provided for, as outlined in this Practice Note.

SARS, however, would like to emphasise that, should the relevant unacceptable practices not cease, SARS will have no alternative than to request the Minister of Finance to recommend to Parliament that the relevant relief and facilitating provisions be withdrawn.