

SOUTH AFRICAN REVENUE SERVICE

**COMPREHENSIVE GUIDE
TO
SECONDARY TAX ON
COMPANIES
(Issue 3)**

Another helpful guide brought to you by the
South African Revenue Service



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Preface

SARS comprehensive guides serve an important function in that they save SARS staff and tax practitioners many hours of research time, serve as a valuable source of reference and assist in promoting compliance with the law.

It is hoped that this guide will assist the public and SARS personnel in gaining a more in-depth understanding of secondary tax on companies (STC). It tackles many of the areas not covered by commercially available textbooks, and provides guidance on areas not specifically addressed by the legislation. SARS would like to express its sincere appreciation to those who submitted comments on the earlier versions of this guide.

While this guide reflects SARS's interpretation of the law, taxpayers who take a different view are free to avail themselves of the normal avenues for resolving such differences.

This guide is not a binding ruling under Part IA of Chapter III of the Income Tax Act, 1962. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

This work reflects the law as amended by the Taxation Laws Amendment Act 17 of 2009, promulgated on 30 September 2009. This guide does not consider changes to company law to be brought about by the Companies Act 71 of 2008. It also does not deal with the significant amendments proposed in the Taxation Laws Amendment Bill, B 28—2010 that are due to come into effect on 1 January 2011 (see 1.8)

For more information you may

- visit the SARS website at www.sars.gov.za,
- visit your nearest SARS branch office,
- contact your own tax advisor / tax practitioner,
- if calling locally, contact the SARS Contact Centre on 0800 00 7277, or
- if calling from abroad, contact the SARS Contact Centre on +27 11 602 2093.

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ABBREVIATIONS

References to statutory provisions

In this guide references to sections, paragraphs and schedules are to sections, paragraphs of schedules and schedules to the Income Tax Act 58 of 1962 unless otherwise indicated.

para	Paragraph
paras	Paragraphs
s	Section
ss	Sections

General

CFC	Controlled foreign company
CGT	Capital gains tax
CISP	Portfolio of a collective investment scheme in property shares
CISS	Portfolio of a collective investment scheme in securities
Commissioner	Commissioner for the South African Revenue Service
Companies Act	Companies Act 61 of 1973
GAAP	Generally Accepted Accounting Practice
IAS	International Accounting Standard
IFRS	International Financial Reporting Standards
LIFO	Last-in-first-out
OECD	Organisation for Economic Co-operation and Development
PBO	Public benefit organisation
PE	Permanent establishment
SA	Republic of South Africa
STC	secondary tax on companies
tax year	In the case of a company, the year of assessment ending during the period of twelve months ending the last day of March
the Act	Income Tax Act 58 of 1962

Tax Court

C	Cape Tax Court (formerly Cape Income Tax Special Court)
F	Federation of Rhodesia and Nyasaland Income Tax Special Court (from 1957 to 1964)
G	Gauteng Tax Court
N	Natal Income Tax Special Court
SCA	Supreme Court of Appeal of South Africa
SR	Southern Rhodesia Income Tax Special Court
T	Transvaal Income Tax Special Court
U	Special Court for the Union of South Africa (from 1 June 1926 to 1950)

Other case law

(A)	Appellate Division of the Supreme Court of South Africa
AC	Law Reports, Appeal Cases, House of Lords
ACLR	Australian Company Law Reports
AD	Reports of the Appellate Division of the Supreme Court of South Africa
AITR	Australian and New Zealand Income Tax Reports
All ER	All England Law Reports
All ER Rep	All England Law Reports Reprint

All SA	All South African Law Reports
ATC	Australian Tax Reports
(C)	Cape Provincial Division of the Supreme Court of South Africa
(CA)	Court of Appeal Reports, by Johnston (NZ) 1867 – 1877
CA (NSW)	Court of Appeal, New South Wales
Ch	Law Reports, Chancery Division
CIR	Commissioner for Inland Revenue
CLR	Commonwealth Law Reports
CPD	Reports of the Cape Provincial Division of the Supreme Court of South Africa
C: SARS	Commissioner for the South African Revenue Service
DCT	Deputy Commissioner of Taxation
FCT	Federal Commissioner of Taxation (Australia)
HCA	High Court of Australia
IRC	Inland Revenue Commissioners
KB	Law Reports, King's Bench Division
LJ Ch	Law Journal Reports, Chancery, New Series 1831 – 1846
LT	Law Times Reports 1859 – 1947
(RAD)	Appellate Division of the High Court, Rhodesia
SA	South African Law Reports
SATC	South African Tax Cases
(SCA)	Supreme Court of Appeal of South Africa
SIR	Secretary for Inland Revenue
(SRAD)	Appellate Division of the High Court, Southern Rhodesia
(T)	Transvaal Provincial Division of the Supreme Court of South Africa
TBDR	Tax Board Decisions Reports
TC	Reports of Tax Cases, England
(W)	Witwatersrand Local Division of the Supreme Court of South Africa
WLR	Weekly Law Reports

Chapter 1 – Introduction and background

1.1 Methods of taxing dividends

It is generally accepted that there should be neutrality in the taxation of dividends. In other words, economic double taxation (as opposed to juridical double taxation) should be avoided by only taxing corporate profits once. If this is not done, it becomes unattractive to carry on a trade through a company, and individuals will simply trade in their own names or in partnership.

Internationally there are many ways in which dividends are taxed, but the three main methods of taxing dividends are as follows:

1.1.1 *The classical system*

Under this system the company pays tax on its profits and the shareholders pay tax in full on any dividends received. The main disadvantage of this method is economic double taxation. Supporters of the system argue that it provides simplicity and neutrality, and that economic double taxation is an acceptable price to pay for limited liability and other benefits associated with corporate personality. They also argue that the pure classical system discourages the formation of vertical groups which have been associated with corporate governance problems, corporate tax avoidance and a greater concentration of economic power. Some countries apply a modified version of the classical system known as the 'reduced rate system'. An example is the United States of America which has inter-corporate dividend concessions and a lower tax rate on dividends for individual shareholders. In South Africa before 1 March 1990 dividends were taxable in the hands of shareholders, less a 'dividend allowance' based on a sliding scale with a minimum allowance of one-third of the dividend. Companies were subjected to an undistributed profits tax ('UPT')¹ in order to encourage dividend distribution (the opposite of STC which encourages dividend retention). The UPT system was beset with problems such as dividend stripping, which necessitated the introduction of a number of complex anti-avoidance measures, namely, s 8B of the Act (advances, loans or payments made to certain shareholders deemed to be dividends in certain circumstances), s 8C (proceeds of certain shares deemed to be dividends) and s 8D (inclusion in income of dividends distributed on certain shares constituting trading stock). With the exemption from tax of domestic dividends, these measures were repealed.

1.1.2 *The imputation system*

Typically under this system the company pays tax on its profits and withholds a further amount of tax when a dividend is distributed to its shareholders. The dividend is then subjected to tax in the shareholder's hands by grossing up the net dividend, and a rebate is given for the underlying withholding tax and / or corporate tax. The extent that a shareholder is permitted to 'drill down' into the company to access the corporate tax for rebate purposes varies from country to country. Generally shareholders with a significant interest (at least 10%) are permitted a rebate for the underlying corporate tax, while small portfolio investors are only credited with any withholding tax (this is known as the partial imputation system). One reason for this is that small investors would not normally have access to the information needed to determine the attributable corporate tax. Before 1941, South African companies paid income tax on profits and shareholders paid tax on dividends. To avoid super tax for their shareholders companies would not declare dividends. In 1941 a system was introduced under which company profits were apportioned to shareholders. The system gave rise to cash flow difficulties for minority shareholders who did not necessarily have enough dividend

¹ UPT was first introduced in 1955 and applied to private companies.

income to discharge the tax liability. To solve this problem a levy was introduced on the company that acted as an advance payment. Problems were experienced with the loss of levy certificates and in tracing shareholders. The apportionment system was finally abolished in 1952.

Since 2000 South Africa taxes certain foreign dividends with a tax rebate provided under s 6quat, when applicable, for any withholding tax. Australia adopted a full imputation system in 1987. Other countries using this method include Canada, New Zealand and Mexico. In recent years there has been a move away from the full imputation system with the United Kingdom being a leader in this trend. One of the reasons for this has been the loss of revenue as a result of extending imputation to cross-border situations and problems with non-discrimination clauses in tax treaties. The system is also difficult to administer because of the need to inform shareholders of their share of the underlying corporate tax.

1.1.3 The corporate level system

Under this system, also known as the dividend exclusion system, the tax is imposed only at the corporate level, with dividends being tax free in the hands of shareholders. STC falls in this category, and is imposed on the amount by which a dividend declared exceeds the sum of dividends received during the assessment period (known as the dividend cycle). As its name suggests, STC is a second-stage tax on corporate profits. The first stage 'normal tax' is imposed on an annual basis on corporate profits (or more accurately on 'taxable income'). The second-stage STC is determined when a company's after-tax profits are distributed.

The deduction of dividends received from dividends paid prevents economic double taxation of corporate profits flowing between companies in South Africa. Local dividends are exempt from tax in the hands of shareholders under s 10(1)(k) of the Act, while non-residents receive dividends free of any withholding tax.² Non-resident companies are not subject to STC. Dividends declared by non-resident companies are either taxed in the hands of resident shareholders or are exempt in their hands via a participation exemption. An incoming foreign dividend received by a resident company will form part of that company's revenue profits available for distribution. Such profits will be subject to STC when on-distributed. As a rule, any incoming foreign dividends do not qualify as a deduction for STC purposes. Some foreign dividends are, however, deductible, such as, for example, when the foreign dividend originated from a dividend that was subject to STC (see 3.10.5).

1.1.4 Comparison of the three systems

The table below illustrates how the three systems operate. A company tax rate of 28%, withholding tax of 10%, STC rate of 10% and an individual tax rate of 40% have been assumed. The table is not indicative of the actual effective tax rates under the three systems. For example, although the classical system shows a higher tax take than the STC system according to the table, it is likely that countries adopting the classical system would apply a lower rate of tax to dividend income.

	Classical System R	Imputation System R	STC System R
<i>Company</i>			
Profit before tax	100,00	100,00	100,00
Less: Income tax	<u>(28,00)</u>	<u>(28,00)</u>	<u>(28,00)</u>
Profit after tax	72,00	72,00	72,00
Less: STC	<u>-</u>	<u>-</u>	<u>(6,55)</u>
Dividend declared	72,00	72,00	65,45

² The non-resident shareholders' tax on dividends (NRST) previously contained in s 42 of the Act was abolished in respect of dividends declared or interim dividends approved after 1 October 1995.

Less: Withholding tax	-	(7,20)	-
Amount paid to shareholder	<u>72,00</u>	<u>64,80</u>	<u>65,45</u>
<i>Shareholder</i>			
Amount received	72,00	64,80	65,45
Withholding tax	-	7,20	-
Company income tax	-	<u>28,00</u>	-
Taxable dividend	<u>72,00</u>	<u>100,00</u>	-
Income tax	28,80	40,00	-
Less: Rebate	-	(35,20)	-
Net tax payable	<u>28,80</u>	<u>4,80</u>	-
	R	R	R
Tax borne by company	28,00	28,00	34,55
Tax borne by shareholder	<u>28,80</u>	<u>12,00³</u>	-
Combined tax	<u>56,80</u>	<u>40,00</u>	<u>34,55</u>
Net amount after all taxes	43,20	60,00	65,45

1.1.5 International comparisons

In any comparative study of dividend taxing systems, it is imperative to consider the taxes imposed at both the corporate and the shareholder level. Some commentators have claimed that STC results in an uncompetitive corporate tax rate. However, they ignore the fact that South Africa does not impose a dividend withholding tax, and exempts domestic dividends from income tax in the hands of shareholders. According to an OECD study of the 2005 combined corporate tax rate and tax rate on dividends in shareholders' hands, South Africa had the fifth-lowest combined rate (36,9%) when compared to the 26 OECD member countries surveyed.

1.2 When was STC introduced?

STC was introduced by s 34(1) of the Income Tax Act 113 of 1993, which inserted ss 64B and 64C into Part VII of Chapter II of the Income Tax Act 58 of 1962. Under s 34(2) these provisions came into operation on 17 March 1993.

1.3 Reasons for the introduction of STC

1.3.1 Lowering of the company tax rate

The company rate of tax at the time of the introduction of STC was regarded as being too high in the context of the global economy. STC was introduced at a rate of 15% and the company rate was reduced from 48% to 40% for companies with tax years falling within the year ending 31 March 1994. However, about fourteen months later the rate was increased from 15% to 25% with effect from 22 June 1994, while the company rate was reduced from 40% to 35%. The large increase in the rate of STC served as a strong disincentive for companies to distribute dividends and this had a negative impact on STC collections. It also prompted many companies to issue capitalisation shares instead of cash dividends.

For dividends declared on or after 14 March 1996 the rate of 25% was reduced to 12,5% and it remained at that level until 30 September 2007. On 1 October 2007 the rate was reduced to 10%. Clearly there is a fine dividing line between stimulating growth through the retention of profits and the loss in tax revenue that results from fewer dividends being

³ The taxes borne by the shareholder comprise the withholding tax of R7,20 plus income tax payable of R4,80 = R12,00.

distributed. The practice of issuing capitalisation shares has become less popular in recent years and there has been a move back to declaring cash dividends. The decline in popularity of the capitalisation issue probably stems from

- shareholders preferring cash dividends rather than being saddled with small numbers of capitalisation shares ('odd lots'),
- the administrative burden that accompanies an offer of a choice of cash or scrip dividends,
- the growing contingent liability for STC that arises when capitalisation shares are issued. STC will eventually become payable when the 'tainted' share capital or share premium is repaid; and
- the perception in the market that dividends do count in determining share prices, and that the share prices of companies that issue capitalisation shares are adversely affected.

1.3.2 Growth stimulation through self-financing

STC acts as an incentive for growing companies to reinvest their profits. The more a company exploits investment opportunities and finances itself, the lower its tax rate will be. The tax is intended to stimulate job creation and domestic demand.

1.3.3 Facilitation of tax collection

A disadvantage of the systems that seek to tax dividends in the hands of shareholders is that tax collection becomes more difficult. Experience has shown that some shareholders do not declare their dividend income. The introduction of STC eliminated this problem – at least in so far as South African resident companies are concerned. It is far easier for SARS to collect the STC from the smaller and more sophisticated corporate tax base than to collect income tax on dividends from numerous shareholders. Furthermore, the opportunities for tax avoidance are more limited. For example, South Africa faced many dividend-stripping schemes during the period that it taxed dividends in the hands of shareholders.⁴ Such schemes are ineffective in the context of STC. Since CGT was introduced, STC collections have been further enhanced by making capital profits derived after 1 October 2001 subject to STC on liquidation, winding-up, deregistration or final termination of the company's corporate existence. STC is payable in a shorter time frame than income tax which also accelerates tax collection.

1.4 STC and non-residents

South Africa's double taxation agreements generally list STC as a tax covered by the relevant treaties. For example, Article 2(3)(a)(ii) of the agreement for the avoidance of double taxation with the United Kingdom lists STC as a tax covered by the treaty and the note at the end of the treaty recognises STC as a tax on the profits of South African companies. Similarly, Article 2(1)(b)(ii) of the agreement for the avoidance of double taxation with the United States lists STC as a tax covered by the treaty. As a result, South Africa's treaty partners will usually give a tax credit for the tax, particularly when the shareholder has a significant interest.⁵ Small portfolio investors and persons based in tax havens are less likely

⁴ For example, see the landmark case of *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A), 45 SATC 241, and more recently *CIR v Bobat & others* 2003 (N), 67 SATC 47, which involved the 'share premium watering-down' scheme.

⁵ For example, see Article 23(1)(b) of the agreement with the United States, which grants a credit for 'South African tax' paid when a US company owns at least 10% of the voting stock of a South African resident company.

to obtain a tax credit, although this will depend on the domestic law of the non-resident's home country. South Africa does not impose any withholding tax on dividends. In *Volkswagen of South Africa (Pty) Ltd v C: SARS*⁶ a South African-resident wholly owned subsidiary of a German holding company sought to obtain a rate of STC of 7,5% under article 7 of the tax treaty with Germany. The court found that there were substantial differences between STC and a withholding tax, and it was therefore not substantially similar to a withholding tax. STC was a tax on a company declaring a dividend and not a tax on the recipient shareholders. It was not a tax on dividends as contemplated in the tax treaty and accordingly fell outside the ambit of the article.

Up until years of assessment ending on 31 March 1996 STC was levied on the South African-sourced profits of foreign companies. However, with effect from years of assessment ending on or after 1 April 1996 non-resident companies were exempted from paying STC and the rate of tax applicable to branches/agencies of such companies was increased by 5%. With effect from the 2006 tax year the tax on the branches or agencies of non-residents has been reduced to 34% as compared to the normal corporate rate of 29%. For the 2009 tax year the normal corporate rate has been reduced to 28% and the tax rate on the taxable income of non-residents has been reduced to 33%.

1.5 Rates of STC

Table 1 – STC rates

Period	STC rate (%)
17 March 1993 – 21 June 1994	15
22 June 1994 – 13 March 1996	25
14 March 1996 – 30 September 2007	12,5
1 October 2007	10

The combined rate applicable to the year ending 31 March 2010, assuming a company declares all its available profits as a dividend and has no other accumulated profits, is 34,55% determined as follows:

	R
Revenue profit	100,00
Less: Income tax	(28,00)
Available for distribution	72,00
Less: STC 10/110 x R72	(6,55)
Dividend	<u>65,45</u>
Overall effective rate	%
Income tax	28,00
STC	<u>6,55</u>
Total	<u>34,55</u>

The revenue profit of R100 is thus applied as follows:

⁶ [2008] JOL 21746 (T), 70 SATC 195.

	R
Revenue profit	100,00
Less: Normal tax (28%)	(28,00)
Dividend	(65,45)
STC	<u>(6,55)</u>
Total	<u>Nil</u>

The combined rate of tax on a capital profit⁷ is determined as follows:

	R
Capital profit	100,00
Less: CGT (R100 x 50% x 28%)	<u>(14,00)</u>
Available for distribution	86,00
STC 10/110 x R86,00	<u>(7,82)</u>
Dividend	<u>78,18</u>
Overall effective rate	%
CGT	14,00
STC	<u>7,82</u>
Total	<u>21,82</u>

The capital profit of R100 is thus applied as follows:

	R
Capital profit	100,00
Less: CGT	(14,00)
Dividend	(78,18)
STC	<u>(7,82)</u>
Total	<u>Nil</u>

1.6 Do other countries have STC?

Taxes on distributed profits imposed solely at corporate level are still fairly rare. India introduced a tax on distributed profits on 1 June 1997.

In Estonia companies are not taxed on their profits but pay a distribution tax on distributed profits. Domestic dividends are not taxed in the hands of shareholders.

1.7 What dividends are included?

The following types of dividends are subject to STC:

- Amounts comprising dividends as defined in the definition of 'dividend' in s 1.
- Amounts deemed to be dividends under s 64C.

1.8 Pending changes to the system of taxing dividends

On 21 February 2007 the Minister of Finance announced that STC would be phased out and replaced with a dividend withholding tax. The legislation governing the new withholding tax, known as the 'dividends tax' is contained in Part XIII of Chapter II of the Act. The dividends tax provisions are contained in ss 64D to 64N, while the value extraction tax provisions –

⁷ The example assumes that the entire capital profit is subject to STC. In other words, it is declared on a going concern basis, or in the case of liquidation or deregistration, it is a post-1 October 2001 capital profit.

which fulfill a similar role to the deemed dividend provisions of s 64C – are contained in ss 64O to 64R.

Before the dividends tax can be implemented a number of South Africa's double tax treaties which provided for a zero-rate withholding tax must be amended to provide for an increased withholding rate. At the time of writing this guide the treaties had been renegotiated but the ratification process had not been completed. The dividends tax comes into operation on a date determined by the Minister by notice in the *Gazette*, which date must be at least three months after the date of the notice.⁸ The exact date when the new tax will be introduced is not known at this stage.

Changes proposed to come into operation on 1 January 2011

The following are some of the changes proposed in the Taxation Laws Amendment Bill, B 28—2010 that was introduced on 24 August 2010. These changes will have a significant impact on STC:

- A new definition of a 'dividend' was inserted in s 1 by s 4(1)(c) of the Revenue Laws Amendment Act 60 of 2008 and was due to come into operation when the 'dividends tax' was introduced. It is now proposed that the new definition will come into operation on 1 January 2011 (clause 138(1)(b)).
- It is proposed that a buy-back of shares by a JSE-listed company be excluded from the new definition of a 'dividend'. This amendment applies in respect of years of assessment commencing on or after 1 January 2011 (clause 145(1)(a) and (2)).
- A definition of 'contributed tax capital' was inserted in s 1 by s 4(1)(b) of the Revenue Laws Amendment Act 60 of 2008. This was due to come into operation when the new dividends tax was introduced but has now been brought forward to 1 January 2011 (clause 138(1)(b)).
- Section 64B(5)(c) is to be deleted with effect from 1 January 2011 (clause 68(1)(f) and (2)).

⁸ Section 53(2) of the Taxation Laws Amendment Act 17 of 2009.

Chapter 2 – The definition of ‘dividend’ in s 1 of the Act

2.1 Structure of the definition

The dividend definition in s 1 is a formidable piece of legislation. The complexity stems from the content and structure of the definition, as well as from the style of drafting. It was mostly drafted at a time when plain English drafting was unheard of and 200+ word sentences were not frowned upon.

The definition is structured as follows:

- *Introduction* – the opening words of the definition state that a dividend is an amount distributed by a company (other than a tax-exempt institution to which s 10(1)(d) applies) to its shareholders, subject to the inclusions and exclusions below.
- *Inclusions* (paras (a) to (cB)) – these deem certain amounts to be dividends.
- *Exclusions* (paras (e) to (j)) – these exclude certain amounts as dividends.
- *The three provisos* (paras (i), to (v) of the first proviso and the second and third provisos) – these deal with various scenarios in which reserves have been capitalised. The common principle underlying these provisos is that reserves retain their character despite being capitalised. The third proviso deems unrealised profits to be profits regardless of whether the amounts are recognised in the company’s financial records.

A word of warning

When interpreting the dividend definition it is imperative that the entire definition be read and not just a particular paragraph in isolation. What at first glance appears to be included may be excluded later on in the definition. For example, the nominal value of capitalisation shares is included in para (b) but the nominal value of capitalisation shares paid out of share premium is excluded by para (e) and the nominal value of equity capitalisation shares is excluded by para (h). And what appears to be excluded may be included elsewhere. For example, when reserves are transferred to the share premium account, a subsequent reduction in share premium may appear to be excluded by para (f), but will be included by para (i) of the first proviso read with para (iii) of that proviso.

The dividend definition has undergone substantial amendment in recent years and this guide generally only reflects the current law. It is accordingly important when dealing with a specific case to ascertain the law applicable at the time, and where necessary to consult previous editions of this guide.

Table 1 – Quick reference guide to the definition of ‘dividend’

Provision	Description
Introduction	A dividend means any amount distributed by a company (other than a s 10(1)(d) institution such as a pension, pension preservation, provident, provident preservation or retirement annuity fund) to its shareholders.
INCLUSIONS	
Paragraph (a)	Includes any profits distributed in the course of the winding up, liquidation, deregistration or final termination of a company
Paragraph (b)	Includes <ul style="list-style-type: none"> • any profits distributed by a company that is not being wound up, liquidated, or deregistered or the corporate existence of which is not finally terminated.

	<ul style="list-style-type: none"> • the nominal value at the time of issue of <ul style="list-style-type: none"> ➤ any capitalisation shares awarded to shareholders, and ➤ any bonus debentures or securities awarded to shareholders. <p>Note: The nominal value of certain capitalisation shares is excluded by paras (e) and (h) below.</p>
Paragraph (c)	Includes any reduction of the profits of a company as a result of <ul style="list-style-type: none"> • the reduction of its capital, or • the acquisition, cancellation or redemption of its own shares.
Paragraph (cB)	Includes any reduction of the profits of a company (S), if <ul style="list-style-type: none"> • it holds shares in any other company (H) which is a shareholder in relation to it; and • those shares (the H shares) are cancelled,
EXCLUSIONS	
Paragraph (e)	Excludes the nominal value of capitalisation shares awarded out of the share premium account,
Paragraph (f)	Subject to the first proviso, any repayment of share capital or share premium (that is, only ‘pure’ share capital or share premium is excluded).
Paragraph (g)	Any amount distributed by a company (S) to a shareholder (H) when S and H form part of the same group of companies as defined in s 41, to the extent that H reduces the cost of the shares in S in accordance with GAAP as a result of the distribution.
Paragraph (h)	Nominal value of capitalisation shares awarded as part of ‘equity share capital’ of the company.
Paragraph (i)	Any bonus distributed by a co-operative to the extent that it is allowable as a deduction from the income of the co-operative under s 27.
Paragraph (j)	Any amount distributed by way of the redemption of a participatory interest in a portfolio, arrangement or scheme contemplated in para (e) of the definition of a ‘company’.
PROVISOS	
The first proviso	
Paragraph (i)	This paragraph deals with the situation in which a company has transferred profits or reserves to the share capital or share premium account on or after 1 January 1974. These profits retain their capital or revenue nature and are deemed to be available for distribution in the event of a distribution (so-called ‘tainted’ share capital or share premium). The provision applies <ul style="list-style-type: none"> • before or during winding-up, and • regardless of whether the company has any other profits available for distribution
Paragraph (ii)	This paragraph applies when a company has more than one class of shareholder. It states that the capitalised profits in para (i) of the first proviso must be allocated across the different classes in accordance with their respective participation rights. The amount allocated will be available for distribution to the relevant class of shareholder.
Paragraph (iiA)	This paragraph applies when a class of shares is converted into a new class of shares. For the purposes of para (i) and (ii) of the first proviso, any profits that were available for distribution to the old class are deemed

	to be available to the new class. Any restrictions on distribution of those profits imposed on the new class must be disregarded.
Paragraph (iiB)	This paragraph applies when reserves have been capitalised and the relevant shares are cancelled without compensation. The cancelled share capital and related share premium may be transferred to a special reserve. If the cancelled share capital, related share premium or special reserve is paid out to shareholders the capitalised profits will retain their nature and constitute a dividend. This proviso is subject to paras (iiA) and (iv) of the first proviso.
Paragraph (iii)	This paragraph applies when cash or assets are given to shareholders following <ul style="list-style-type: none"> • a partial reduction of the capital of a company, or • acquisition, cancellation or redemption of the company’s shares. <p>The amount paid is deemed to be a profit distributed to the extent of the available reserves (including capitalised reserves). For this purpose the profits retain their nature (that is, capital or revenue).</p>
Paragraph (iiiA)	In essence this proviso deems a company having different classes of shares to have distributed a dividend to the extent that share capital or share premium contributed by one class of shareholders is diverted to another class of shareholders.
Paragraph (iv)	This paragraph applies when <ul style="list-style-type: none"> • a company has lost some of its share capital or share premium as a result of losses incurred, • that share capital or share premium includes capitalised reserves, and • is reduced to take account of the losses. <p>In this case the losses must be set off against the capitalised reserves in determining the amount available for distribution. If some shareholders are entitled to participate in capital profits and others in revenue profits, capital losses must as far as possible be set off against capital profits and revenue losses against revenue profits.</p>
Paragraph (v)	This paragraph applies when <ul style="list-style-type: none"> • a company’s share capital or share premium account includes capitalised reserves, • the company is wound up or liquidated, and • some of the share capital or share premium has been lost as a result of losses. <p>The proviso ensures that</p> <ul style="list-style-type: none"> • capitalised capital profits are matched against realised capital losses, • capitalised revenue profits are matched against realised revenue losses, and • ensures that when assets are distributed <i>in specie</i>, the capitalised profits are reduced by any net unrealised losses.
The second proviso	An amount transferred from the share premium account to a reserve continues to be share premium.
The third proviso	‘Profits’ for the purpose of the definition of ‘dividend’ includes realised and unrealised profits of a company whether or not those unrealised profits

have been recognised in the financial records of the company.

2.2 What is a dividend?

In *Henry v Great Northern Railway Co*⁹ Knight-Bruce LJ said that a dividend meant ‘a share of profits’.

Under the opening words of the definition in s 1 of the Act, a dividend means ‘any amount distributed by a company’.

‘Any amount’

The word ‘amount’ has been judicially considered in relation to the gross income definition. In *W H Lategan v CIR*¹⁰ Watermeyer J stated the following:

‘In his Lordship’s opinion the word “amount” had to be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer whether corporeal or incorporeal which had a money value.’

In *CIR v Butcher Bros (Pty) Ltd*¹¹ Feetham JA stated that the word ‘amount’ meant

‘an amount having an ascertainable money value’.

In *Lace Proprietary Mines Ltd v CIR*¹² a company disposed of mineral rights in exchange for shares in another company. The court held that the ‘true consideration’ was the shares, which had to be valued, and the value should be determined by enquiring what price could have been obtained for the shares, by adopting some reasonable method of sale on the date in question.

In *C: SARS v Brummeria Renaissance (Pty) Ltd and others*¹³ the court held that the question whether a receipt or accrual in a form other than money could be turned into money was but one of the ways in which it could be determined whether it had a money value. It did not follow that if a receipt or accrual cannot be turned into money then it has no money value since the test is objective, not subjective. The fact that a right which has a money value cannot be alienated does not negate that value.

It is submitted that the word ‘amount’ as used in the definition of ‘dividend’ would bear a similar meaning as that determined by the courts in the context of the gross income definition. While the aforementioned cases are arguably more relevant in the context of dividends received, it is submitted that the same principle applies in determining the amount of a dividend declared when an asset is distributed *in specie*. The definition of ‘dividend’ applies to both outgoing and incoming dividends. If the ‘amount’ of an incoming dividend *in specie* is equal to its market value, it follows that the ‘amount’ of the outgoing dividend must be equal to the same amount.

This view also finds support in ITC 1783¹⁴ in which Goldblatt J held that in a barter transaction the expenditure is the value by which a person’s assets have been diminished. When the dividend is declared the shareholder acquires a right to claim the value of the asset from the company, and the company incurs a corresponding liability. When the asset

⁹ (1857) 27 LJ Ch 1 18.

¹⁰ 1926 CPD 203, 2 SATC 16 at 19.

¹¹ 1945 AD 301, 13 SATC 21 at 34.

¹² 1938 AD 267, 9 SATC 349.

¹³ 2007 (6) SA 601 (SCA), 69 SATC 205 at 214.

¹⁴ (2004) 66 SATC 373 (G) at 376.

is distributed, that liability, which is equal to the dividend, is discharged. The topic of distributions *in specie* is discussed in more detail in **2.23**.

‘Distributed’

In *CIR v Legal & General Assurance Society Ltd* Steyn CJ stated the following regarding the meaning of the word ‘distributed’ in the content of the definition of ‘dividend’:¹⁵

‘In my view, effect can be given to this apparent intention of the legislature by ascribing to “distribute”, in the relevant context, the wider meaning of apportion, appropriate, allocate or apply towards.’

2.3 Profits available for distribution

The determination of what constitutes profits available for distribution is a complex and uncertain area of South African law. In answering the question, regard must be had to

- s 90 of the Companies Act,
- the common law rules regarding divisible profits,
- the definition of ‘dividend’ in s 1, and
- the deeming provisions of s 64C.

2.3.1 The Companies Act

The Companies Act does not deal specifically with how dividends must be paid. Section 90 of that Act deals with ‘payments to shareholders’, which would include dividends paid. The term is widely defined in s 90(3) and includes any direct or indirect payment or transfer of money or property to a shareholder by virtue of that shareholder’s shareholding. Certain payments such as a buy-back of shares or the redemption of redeemable preference shares are excluded. Payments to shareholders must be authorised by the company’s articles but may not result in

- a company not being able to pay its debts arising in the ordinary course of business, or
- its consolidated assets fairly valued after the payment being less than its consolidated liabilities.

In the context of deemed dividends, s 64C(2)(f) and (4)(c) require that any prohibition or limitation on the amount of distributable profits contained in the company’s memorandum and articles of association, founding statement or any agreement must be disregarded.

2.3.2 Divisible profits

In determining the profits that are available for distribution, the courts in the United Kingdom developed the legal (as opposed to accounting) concept of ‘divisible profits’, that is, profits available to be divided amongst the shareholders by way of dividend. The United Kingdom courts developed a number of rules for determining divisible profits. These rules are no longer relevant in the United Kingdom as they have been embodied into that country’s Companies Act.¹⁶ Nevertheless, given that South Africa’s company law is based on that of the United Kingdom, they remain relevant in South Africa today. These rules set the outer limit of what a company may legally distribute by way of dividend. However, these rules are always subject to

¹⁵ 1963 (3) SA 876 (A), 25 SATC 303 at 315.

¹⁶ Section 263(1) of the English Companies Act, 1985.

- the company’s memorandum and articles (except when these must be disregarded under s 64C(2)(f) and (4)(c)), and
- s 90 of the Companies Act.

Divisible profits and STC

Should a company choose to distribute a dividend in accordance with the rules governing divisible profits instead of following what in many cases would be a more conservative accounting treatment, such a dividend will be a dividend for the purposes of STC. Furthermore, these rules play an important role in determining what profits are available for distribution in the case of amounts deemed to be dividends under s 64C.

Table 1 – Divisible profits

Case	Principle for determining divisible profits
<i>Guinness v Land Corporation of Ireland</i> , ¹⁷ <i>Cohen v Segal</i> ¹⁸	Dividends may not be paid out of contributed share capital.
<i>Foster v New Trinidad Lake Asphalt Company, Limited</i> ¹⁹	The question what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year.
<i>Lee v Neuchatel Asphalte Co & others</i> , ²⁰ <i>Bolton v Natal Land & Colonization Company</i> , ²¹ <i>Verner v General & Commercial Investment Trust</i> , ²² <i>Re Kingston Cotton Mill Co (No 2)</i> ²³	Dividends may be distributed out of revenue profits without first providing for losses or depreciation of fixed assets.
<i>Verner v General & Commercial Investment Trust</i> ²⁴	Loss or depreciation of current assets must be provided for.
<i>Lee v Neuchatel Asphalte Co & others</i> , ²⁵ <i>Verner v General & Commercial Investment Trust</i> ²⁶ and <i>Ammonia Soda Co, Ltd v Chamberlain & another</i> ²⁷	It is not necessary to first make good past trading losses.
<i>Lubbock v British Bank of South America</i> , ²⁸ <i>Verner supra</i> ²⁹ and <i>CIR v Dirmeik</i> ³⁰	Subject to what is stated below, a realised profit on the sale of a fixed asset may be distributed as a dividend.
<i>Foster v New Trinidad Lake Asphalt Co Ltd</i> ³¹	In arriving at divisible profits, realised profits on sales of fixed assets must first be set off against any current period trading loss or loss on sale of fixed assets.

¹⁷ [1882] 22 Ch 349 (CA) at 375.

¹⁸ 1970 (3) SA 702 (W) at 705–706.

¹⁹ [1901] 1 Ch 208.

²⁰ [1889] 41 Ch 1 (CA) at 18, 26–27.

²¹ [1892] 2 Ch 124.

²² [1894] 2 Ch 239 (CA).

²³ [1896] 1 Ch 331 and [1896] 2 Ch 279 (CA).

²⁴ [1894] 2 Ch 239 (CA) at 266.

²⁵ [1889] 41 Ch 1 (CA) at 18, 26–27.

²⁶ [1894] 2 Ch 239 (CA) at 264–265.

²⁷ [1918] 1 Ch 266, [1916–1917] All ER Rep 708.

²⁸ [1892] 2 Ch 198 at 201–202.

²⁹ At 265–266.

³⁰ 1996 (2) SA 736 (C), 58 SATC 101.

³¹ [1901] 1 Ch 208 at 211–213.

<p><i>Dimbula Valley (Ceylon) Tea Co Ltd v Laurie</i>³²</p>	<p>A surplus on valuation of fixed assets is distributable if</p> <ul style="list-style-type: none"> • the articles authorise it, • the valuation is made in good faith by a competent valuer, and • the surplus is unlikely to fluctuate in the short term. <p>According to <i>Corporate Law</i>³³ an unrealised profit on current assets is also distributable.</p>
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Profits may not be paid out of paid up share capital

In *Guinness v Land Corporation of Ireland Ltd* Cotton LJ stated the following:³⁴

‘From that it follows that whatever has been paid by a member cannot be returned to him. In my opinion it also follows that what is described in the memorandum as the capital cannot be diverted from the objects of the society. It is, of course, liable to be spent or lost in carrying on the business of the company, but no part of it can be returned to a member so as to take away from the fund to which the creditors have a right to look as that out of which they are to be paid.’

The above extract was cited with approval in *Trevor & another v Whitworth & others*,³⁵ the leading case dealing with the principle that a company may not buy back its own shares.

In *Verner v General & Commercial Investment Trust*³⁶ Lindley LJ stated that

‘[i]t has been already said that dividends presuppose profits of some sort, and this is unquestionably true. But the word "profits" is by no means free from ambiguity. The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits’.

After reviewing the United Kingdom authorities, Boshoff J said the following in *Cohen v Segal*.³⁷

‘[A] dividend cannot be declared which has the effect of diverting a portion of the *corpus* of the company to the shareholders. A dividend may thus, generally speaking, only be declared out of profits, and a resolution which declares a dividend to be paid out of the capital of the company is *ultra vires* the company.’

Payments to shareholders can only comprise a return of share capital or a return of profits by way of a dividend (per Clarke JA in *North Sydney Brick & Tile Co Ltd v Darvall*).³⁸

The determination of profits

The word ‘profits’ is not defined in the Companies Act. Section 64B defines ‘profit’ for the purposes of STC as including

³² [1961] Ch 353 at 372–373, [1961] 1 All ER 769 at 780–781.

³³ H S Cilliers, M L Benade, J J Henning, J J du Plessis and, P A Delpont *Corporate Law* 2ed (1992) Butterworths, Durban at 349.

³⁴ [1882] 22 Ch 349 (CA) at 375.

³⁵ [1886-1890] All ER Rep 46.

³⁶ [1894] 2 Ch 239.

³⁷ 1970 (3) SA 702 (W) at 705–706.

³⁸ (1989) 15 ACLR 706 CA (NSW) at 717.

‘any amount deemed in terms of the definition of ‘dividend’ in section 1 to be a profit available for distribution’.

The above definition does not in itself explain how profits are to be determined, but essentially ensures, that profits that have been capitalised by transferring them to share capital or share premium remain profits available for distribution. It is therefore necessary to look to the common law meaning of ‘profits’.

Fletcher Moulton LJ *In Re The Spanish Prospecting Company, Limited* summed up the meaning of the word ‘profits’ as follows:³⁹

‘The word “profits” has in my opinion a well-defined legal meaning, and this meaning coincides with the fundamental conception of profits in general parlance, although in mercantile phraseology the word may at times bear meanings indicated by the special context which deviate in some respects from this fundamental signification. “Profits” implies a comparison between the state of a business at two specific dates usually separated by an interval of a year. The fundamental meaning is the amount of gain made by the business during the year. This can only be ascertained by a comparison of the assets of the business at the two dates.’

In *Foster v New Trinidad Lake Asphalt Company, Limited* Byrne J said that⁴⁰

‘the question what is profit available for dividend depends upon the result of the whole accounts fairly taken for the year . . .’.

Profits are not synonymous with taxable income, since taxable income is determined on a different basis and is not concerned with fair presentation in financial statements. For example, the accelerated capital allowances in ss 12B and 12C of the Act are not intended to write off the qualifying assets over their expected useful lives, but rather to act as an incentive for capital investment. In *Rushden Heel Co Ltd. v Keene (Inspector of Taxes) Rushden Heel Co Ltd. v IRC*⁴¹ the following was stated:

‘Profits, as it seems to me, must not be confused with receipts. Profits consist of a sum arrived at by adding up the receipts of a business and by deducting all the expenses and losses, including depreciation and the like, incurred in carrying on the business.’

While the judge in this case described the more conventional accounting concept of profit, he did not address the issue of unrealised profits associated with a distribution *in specie*.

In *Lee v Neuchatel Asphalte Co & others* Lindley LJ stated the following:⁴²

‘There is nothing at all in the Acts about how dividends are to be paid, nor how profits are to be reckoned; all that is left, and very judiciously and properly left, to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into a capital account, what into an income account, is left to men of business.’

But Mahoney JA tempered these remarks in *Marra Developments Ltd v BW Rofe Pty Ltd* when he said:⁴³

‘It has been said that matters that may be taken into account in determining revenue profit are to be determined by “men of business” and, presumably, those advising them in the keeping of their accounts . . . but this does not depend upon, eg the whim or idiosyncrasy of the persons concerned, and no doubt the court will, in an appropriate

³⁹ [1911] 1 Ch 92 at 98.

⁴⁰ [1901] 1 Ch 208.

⁴¹ [1946] 2 All ER 141, 25 ATC 337.

⁴² [1889] 41 Ch 1 (CA) at 23.

⁴³ (1977) 3 ACLR 185 CA (NSW) 186 at 196.

case, hold that particular items should have been brought to account in determining whether a revenue profit has been earned or earned in a particular period.’

It is evident from the above cases that the exact meaning of profits is far from clear. But the obvious starting point will be the company’s annual financial statements drawn up in accordance with GAAP.

The third proviso to the definition of a ‘dividend’ reads as follows:

‘Provided further that for the purposes of this definition “profits” includes realised and unrealised profits of a company whether or not those unrealised profits have been recognised in the financial records of the company.’

Unrealised profits

*In Dimbula Valley (Ceylon) Tea Co Ltd v Laurie*⁴⁴ Buckley J said:

‘Every profit and loss account of a trading concern which opens and closes with a stock figure necessarily embodies an element of estimate. The difference between ascertaining trading profits by, amongst other things, estimating the value of the stock in hand at the beginning and end of the accounting period, and ascertaining capital profits by comparing an estimated value of the assets with their book value, appears to me to be a difference of degree but not of principle. Moreover, if a company has fluid assets available for payment of a dividend, I can see nothing wrong in its using those assets for payment of a dividend, and at the same time, as a matter of account, treating that dividend as paid out of capital surplus resulting from an appreciation in value of unrealised fixed assets.’

On the question of unrealised profits see **2.23**.

2.4 Inclusions – Liquidation, deregistration and final termination dividends (para (a))

2.4.1 The law

Paragraph (a) of the definition of a ‘dividend’ includes as an amount distributed

‘in relation to a company that is being wound up, liquidated or deregistered or the corporate existence of which is finally terminated, any profits distributed in the course of the winding up, liquidation, deregistration or final termination of that company: Provided that any profits distributed by the liquidator of the company are deemed for purposes of this definition to have been distributed by the company’.

2.4.2 Historical background

Before the introduction of STC, the original purpose of para (a) was to ensure that revenue profits distributed by a liquidator during the course of winding-up were included in the definition of ‘dividend’. The rule was necessary because under common law such distributions would otherwise be regarded as a return of capital. This was confirmed in *New Mines Ltd v CIR* in which Stratford CJ said the following:⁴⁵

‘Thus, post-liquidation distributions of profits are not income whether the recipient be a shareholder who bought originally with a view to resale or bought to hold as an investment. This view is in agreement with the decision in *Inland Revenue Commissioners v Burrell* (1924, 2 KB 52⁴⁶).’

⁴⁴ 1961 Ch 353 at 373, [1961] 1 All ER 769.

⁴⁵ 1938 AD 455, 10 SATC 9 at 15.

⁴⁶ 9 TC 27.

This principle has also been recognised in Australia in the cases of *Webb v FCT*,⁴⁷ *DCT (NSW) v Stevenson*⁴⁸ and *Parke Davis & Co v FCT*.⁴⁹

Since the introduction of STC, para (a) has undergone a number of amendments, which are summarised in the table below.

Table 1 – Amendments to para (a) of definition of ‘dividend’ since 1975

Amending Act	Description of amendment	Applies to
Revenue Laws Amendment Act 74 of 2002	<ul style="list-style-type: none"> Includes final termination of corporate existence as a mode of termination to cater for external companies. Includes capital profits arising after 1 October 2001 and provides a rule for determining the post-1 October 2001 portion of capital profits arising on disposal of pre-CGT assets. 	Dividends declared on or after 1 January 2003.
Revenue Laws Second Amendment Act 32 of 2005	<ul style="list-style-type: none"> Includes deregistration as a mode of termination. Includes distributions in anticipation of liquidation, deregistration or termination. 	Dividends declared on or after 8 November 2005.
Revenue Laws Amendment Act 35 of 2007	<ul style="list-style-type: none"> The exclusion of pre-1 October 2001 capital profits was deleted. The reference to ‘in cash or otherwise’ was deleted. The reference to profits distributed in anticipation of winding-up, liquidation, deregistration or final termination of a company was deleted. The proviso was substituted in order to delete reference to the calculation of pre-1 October 2001 capital profits. 	Any amount distributed on or after 1 January 2009.

The amendments effected by the Revenue Laws Amendment Act 74 of 2002 resulted in post-1 October 2001 capital profits becoming subject to STC. Before the amendment such distributions could be extracted from a company STC free although such amounts would constitute a capital distribution (that is, proceeds) for CGT purposes. As a result of the change distributions out of post-1 October 2001 capital profits no longer constitute proceeds on disposal of the relevant shares for CGT purposes. In other words, what was once subject to CGT has become subject to STC. The effect of the change has been to accelerate the collection of tax. Instead of only collecting CGT upon assessment when the company is dissolved or deregistered,⁵⁰ STC is now payable by not later than the end of the month following the distribution.⁵¹

⁴⁷ [1922] 30 CLR 450.

⁴⁸ [1937] 59 CLR 80.

⁴⁹ [1959] 101 CLR 521.

⁵⁰ See para 77 of the Eighth Schedule which sets out the time of disposal of shares in a company that is being wound up or deregistered.

⁵¹ Section 64B(7).

The purpose of the amendments effected by Act 32 of 2005 was to bring para (a) in line with the exemption from STC contained in s 64B(5)(c). Despite the above amendments, some profits that are exempt from STC under s 64B(5)(c) remained included in the definition of ‘dividend’, namely

- pre-1993 profits,
- when a company becomes a resident on or after 1 October 2001
 - pre-residence profits, and
 - the pre-residence portion of a capital profit arising when a pre-residence asset is disposed of after the date of residence,
- The amendments effected by s 5(1)(c) and (d) of Act 35 of 2007 have had the effect of widening the scope of para (a) to include profits of a capital nature derived before 1 October 2001. From an STC point of view the amendment has had little impact, since such profits are exempt from STC under s 64B(5)(c). The words ‘in cash or otherwise’ were removed because they are considered superfluous, particularly since the term ‘profits’ is now defined in the third proviso to include unrealised profits. It is unclear why the term deregistration is dealt with in para (a), since it should not be possible to make a distribution after a company has been deregistered. Distributions in anticipation of the date of liquidation or deregistration are addressed in para (b).

2.4.3 Meaning of winding-up, liquidation, deregistration and final termination

Paragraph (a) applies to a company that is being

- wound up,
- liquidated,
- deregistered, or
- the corporate existence of which is finally terminated.

The terms ‘liquidation’ and ‘winding-up’ would appear to bear the same meaning. In fact, the Afrikaans text uses the single word ‘likwidasie’. In *Ex Parte Trans-African Staff Pension Fund*⁵² Dowling J held that the term ‘winding-up’ meant ‘winding-up in the company law sense and nothing more or less’. He rejected the argument that the expression included a judicial management order. Under s 343 of the Companies Act a company may be wound up

- by the court, or
- voluntarily.

Section 343(2) provides that a voluntary winding-up may be

- a creditors’ voluntary winding-up, or
- a members’ voluntary winding-up.

In the context of South African company law the word ‘deregistration’ refers to the procedure under s 73 of the Companies Act. In *ITC 1306*⁵³ it was held that the terms ‘winding-up’ or ‘liquidation’ mean a winding-up under the Companies Act and do not include a deregistration under s 73. Melamet J described deregistration as

‘some irregular proceeding which in fact may have the effect of a dissolution although in law . . . it does not achieve or have this effect’.

⁵² 1959 (2) SA 23 (W).

⁵³ (1980) 42 SATC 139 (T) at 146.

The words ‘liquidation, winding-up and deregistration’ could include a similar procedure under the law of another country.⁵⁴

The term ‘final termination of corporate existence’ was introduced to cater for companies formed under the law of other countries. In some countries a company may lose its corporate existence otherwise than by winding-up or deregistration. For example, in the United States, Delaware corporate law makes provision for a short-form merger procedure under which a subsidiary can be merged into its holding company or a fellow subsidiary, and thereafter the merged company would cease to exist.

2.4.4 Dates of liquidation and deregistration

The dates of liquidation and deregistration are not specified in the Act. It is therefore submitted that these dates must be ascertained from the Companies Act and Close Corporations Act 69 of 1984.

Table 1 – Date of liquidation

Type of winding-up	Section of Companies Act	Date of liquidation
By the court	348	Time of presentation to court of application for winding-up. In <i>Rennie NO v SA Sea Products Ltd</i> ⁵⁵ it was held that the winding-up application is presented when it is filed with the Registrar. This is generally a few days before the petition is actually heard.
Voluntary	352(1)	Time of registration under s 200 of the Companies Act of the special resolution authorising the winding-up.

The same dates apply to the winding-up of a close corporation.⁵⁶

Table 2 – Date of deregistration

Type of company	Statute	Date of deregistration
South African company	Section 73(5) of the Companies Act	Date of publication of the notice of deregistration in the <i>Government Gazette</i> by the Registrar of Companies.
External company	Section 332(4) of the Companies Act	
Close corporation	Section 26(3) of the Close Corporations Act	Date of publication of the notice of deregistration in the <i>Government Gazette</i> by the Registrar of Close Corporations.

2.5 Inclusions – Going concern dividends (para (b))

Paragraph (b) of the definition of ‘dividend’ includes in the ‘amount distributed’

⁵⁴ See s 41(4)(a)(i)(cc) and (b)(iii) which recognise liquidation and deregistration respectively under a foreign law.

⁵⁵ 1986 (2) SA 138 (C).

⁵⁶ Section 66 of the Close Corporations Act confirms that with some exceptions, which do not include ss 348 and 352(1), the provisions of the Companies Act relating to the winding up of a company apply equally to a close corporation.

‘in relation to a company that is not being wound up, liquidated, or deregistered or where the corporate existence of that company is not finally terminated, any profits distributed, including an amount equal to the nominal value, at the time of issue thereof, of any capitalisation shares awarded to shareholders and the nominal value of any bonus debentures or securities awarded to shareholders.’

Paragraph (b) deals with so-called ‘going concern’ dividends.

All profits distributed are included, regardless of their nature, including

- profits of a capital nature,
- profits of a revenue nature, including pre-1993 revenue profits, and
- dividends distributed out of unrealised profits, including those associated with the distribution of an asset *in specie* (see 2.23).

Capitalisation shares

Paragraph (b) includes the ‘nominal value’ of any ‘capitalization shares’. Both terms are defined in s 1 as follows:

“‘[C]apitalization shares” means shares issued by a company, whether by way of a bonus award or otherwise, in such manner that the company’s reserves (including any share premium account) or unappropriated profits are in whole or in part applied in paying up such shares.’

Under the above definition a capitalisation share can be ‘paid’ out of the share premium account or out of any of the company’s reserves, whether realised or unrealised and whether or not of a capital nature.

“‘[N]ominal value” means—

- (a) in relation to shares issued by a company—
 - (i) if the shares have a par value, such par value; or
 - (ii) if the shares do not have a par value, an amount equal to the amount at which the par value of those shares would be determined if the company were to convert the shares into shares having a par value:

Provided that in the case of capitalization shares the nominal value thereof at the time of the issue thereof shall be deemed to be the amount of the company’s reserves (including any share premium account) and unappropriated profits applied in paying up such shares as contemplated in the definition of “capitalization shares” in this section and the amount of such reserves applied in paying up any share premium in respect of the said shares; or

- (b) in relation to bonus debentures or securities issued by a company, the amount of the company’s reserves or unappropriated profits applied in paying up such debentures or securities as contemplated in the definition of “bonus debentures or securities” in this section.’

A company having a stated capital account consisting of shares of no par value must determine the nominal value of its shares as if it were to have converted to shares having a par value. Under s 78(2) of the Companies Act this would be achieved by

‘transferr[ing] to the share capital account of the company the whole of the stated capital account or that part thereof contributed to it by the shares so converted.’

The par value would be determined by dividing the stated capital account by the number of shares to be issued. Under s 78(3) any material fractions must be transferred to a non-distributable reserve.

The above comments apply to South African-registered companies. In the case of foreign companies that are not governed by the Companies Act, it is submitted that for the sake of consistency the same procedure should be followed in determining the nominal value of no par value shares.

Under the proviso to the above definition, if the capitalisation shares are issued at a premium, the full amount will be regarded as the nominal value.

While the nominal value of capitalisation shares is included as a dividend under para (b), the vast majority of capitalisation shares are excluded as dividends under

- para (e) – capitalisation shares paid out of the share premium account (see 2.8), and
- para (h) – capitalisation shares forming part of ‘equity share capital’ (see 2.11).

Bonus debentures or securities

The inclusion of bonus debentures awarded to shareholders was clearly designed to prevent the distribution of reserves to shareholders through the guise of ‘bonus debentures’.

The term is defined as follows:

“[B]onus debentures or securities” means debentures or securities issued by a company, whether by way of a bonus award or otherwise, in such manner that the company’s reserves or unappropriated profits are in whole or in part applied in paying up such debentures or securities.’

Example – Bonus debentures

Facts:

ABC (Pty) Ltd issued bonus debentures to its shareholders by passing the following journal entry:

Dr Retained income	R100 000	
Cr Bonus debentures		R100 000

Six years later the company repaid the debenture holders.

Result:

The issue of the bonus debentures comprises a dividend declared under para (b) of the definition of ‘dividend’.

2.6 Inclusions – Reductions and redemptions of share capital and buy-back of shares (para (c))

Paragraph (c) of the definition of ‘dividend’ includes in the ‘amount distributed’

‘any reduction of the profits of a company as a result of—

- (i) the reduction of the capital of that company; or
- (ii) the acquisition, cancellation or redemption of shares issued by that company.’

Paragraph (c) deals with the following situations:

- The reduction of the *capital* of a company. The capital comprises the share capital and share premium account.

- The buy-back by a company of its own shares under s 85 of the Companies Act.
- The cancellation of a holding company’s shares following the acquisition of those shares from its subsidiary.
- The cancellation of a company’s shares as part of the reconstruction of its capital.
- The redemption of preference shares under s 98 of the Companies Act.

If the capital of a company includes capitalized profits, para (c) must be read with para (iii) of the first proviso which in turn must be read with para (i) of that proviso.

Some additional points to note regarding the buy-back of shares:

- Before a company can buy back its own shares, it must comply with the liquidity and solvency requirements of s 90 of the Companies Act.
- The seller of the shares will qualify for an STC credit if there is a dividend under para (c).
- No dividend will be declared by a subsidiary that acquires the shares of its holding company and retains them as treasury shares, since no amount is distributed to shareholders.

Example 1 – Partial reduction of share capital

Facts:

A company has an issued share capital of 100 000 shares of R1 each and retained income of R200 000. The company reduces the nominal value of its shares to 50 cents and awards its shareholders cash of 80 cents per share.

Result:

The company has returned an amount of R80 000 ($100\,000 \times 0,80$) to its shareholders comprising

- a return of capital of R50 000, being the reduction in the nominal value of the shares, and
- a dividend of R30 000, the amount by which the payment exceeds the reduction in nominal value.

Example 2 – Reduction in capital effected by distribution of assets *in specie*

Facts:

A wholly owned company has an issued share capital of 100 000 shares of R1 each and retained income of R10 000. The company passed a resolution reducing the nominal value of its shares to 50 cents per share. In part fulfillment of that resolution it awarded its shareholder land and buildings with a book value of R60 000 and a market value of R90 000.

Result:

The following amounts are distributed to the shareholder:

- A reduction of capital of R50 000 ($100\,000 \times 50$ cents), and
- A dividend of $R90\,000 - R50\,000 = R40\,000$. The dividend will be regarded as having been paid out of the unrealised capital profit of R30 000 ($R90\,000 - R60\,000$) and out of retained income of R10 000.

Buy-back of shares

The amount of the dividend resulting from an acquisition of shares under s 85 of the Companies Act is determined as follows:

Cash + value of any assets given to shareholder	R XXX
Less: Nominal value of shares bought back	<u>XXX</u>
Dividend	<u>XXX</u>

Note: Any amounts included as a dividend under para (c) will be

- increased when the nominal value of the shares includes capitalised reserves (see para (iii) of the first proviso), or
- reduced when the shares are bought back out of ‘untainted’ share premium (para (f) excludes payments out of the share premium account, but this must be read with para (i) of the first proviso which deems any reserves included in the share premium account to be paid out before any ‘pure’ share premium)).

Example 3 – Buy-back of shares at nominal value*Facts:*

A company’s balance sheet appears as follows:

	R
Share capital (100 000 shares of R1 each)	100 000
Retained income	<u>200 000</u>
	<u>300 000</u>
Assets	<u>300 000</u>

The company buys back 10% of its share capital at R1 per share

Result:

The payment to its shareholders of R10 000 is not a dividend because the amount does not exceed the nominal value of the shares bought back.

Example 4 – Buy-back of shares for amount exceeding nominal value of shares*Facts:*

The facts are the same as Example 3, except that the company buys back 10% of the shares at a price of R1,50 per share.

Result:

The company has paid an amount of R15 000 to the shareholder, which is made up of

- a return of capital of R10 000, being the nominal value of the shares bought back, and
- a dividend of R5 000, the amount by which the payment exceeds the nominal value of the shares bought back.

Example 5 – Buy-back of shares out of share premium account*Facts:*

A company’s balance sheet appears as follows:

	R
Share capital (10 000 shares of R1 each contributed in cash)	10 000
Share premium (contributed in cash)	20 000
Retained income	<u>470 000</u>
	<u>500 000</u>
Assets	<u>500 000</u>

The company buys back 10% of its share capital at R50 per share, making maximum use of its share premium account.

Result:

The company has paid R50 000 to its shareholders (1 000 shares x R50 per share), which is made up of

- a return of share capital of R1 000, being the nominal value of the shares bought back (10 000 shares x 10% = 1 000 x R1 = R1 000),
- a return of share premium of R20 000 (excluded as a dividend under para (f) of the definition of a ‘dividend’), and
- a dividend of R29 000, being the amount by which the payment exceeds the nominal value of the shares bought back plus the share premium.

Acquisition of shares via distribution from subsidiary

Paragraph (c) also deals with the situation in which a holding company acquires its own shares via a dividend from its subsidiary. Typically the subsidiary will acquire its holding company’s shares on the open market and then distribute them to its holding company.

A dividend will arise in the holding company to the extent that its profits available for distribution are reduced as a result of the cancellation of its shares. Note that the subsidiary is not permitted to make an election in respect of the outgoing distribution under s 64B(5)(f).⁵⁷

From an accounting perspective, the dividend received must be accounted for at market value. Paragraph 9 of IAS 18 ‘Revenue’ (issued January 2009) provides as follows:

‘Revenue shall be measured at the fair value of the consideration received or receivable.’

A dividend declared out of pre-acquisition profits may result in the carrying value of the investment in the subsidiary being reduced if its fair value is impaired.

IAS 32 ‘Financial Instruments: Presentation’ (issued January 2009) provides as follows:⁵⁸

‘If an entity reacquires its own equity instruments, those instruments (“treasury shares”) shall be deducted from equity. No gain or loss shall be recognized in profit or loss on the purchase, sale, issue or cancellation of an entity’s own equity instruments. Such treasury shares may be acquired and held by the entity or by other members of the consolidated group. Consideration paid or received shall be recognised directly in equity.’

⁵⁷ The first proviso to s 64B(5)(f) prevents Subco from making an election in respect of the intra-group dividend.

⁵⁸ In para 33.

‘Equity’ is defined as the residual interest in the assets of the entity after deducting all its liabilities.⁵⁹ It includes funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments.⁶⁰

The deduction from ‘equity’ therefore covers any reduction in the company’s retained income as a result of the cancellation of the company’s shares (that is, the inclusion envisaged by para (c)).

Example 6 – Shares acquired by holding company via distribution from subsidiary

Facts:

Holdco, a company listed on the JSE, owns 100% of Subco. In 2009 Subco acquired 10% of Holdco’s shares on the JSE at a cost of R50 000. In March 2010 Subco distributed these shares to Holdco as a dividend *in specie*. Immediately before this transaction, Holdco’s balance sheet appeared as follows:

	R
Share capital	100 000
Revenue reserves	<u>400 000</u>
	<u>500 000</u>
Shares in Subco	<u>500 000</u>

After the buy-back, Holdco’s balance sheet appeared as follows:

	R
Share capital	90 000
Revenue reserves	<u>410 000</u>
	<u>500 000</u>
Shares in Subco	<u>500 000</u>

When Holdco received the dividend, it passed the following journal entries:

Dr Share capital	R10 000	
Dr Retained income	R40 000	
Cr Dividend received		R50 000

Result:

The reduction in retained income of R40 000 is deemed to be a dividend under para (c) of the definition of ‘dividend’. Holdco will have an STC credit of R50 000 in respect of the dividend received. Thus Holdco’s net amount will be

	R
Dividend received	50 000
Less: Dividend declared (para (c))	<u>(40 000)</u>
STC credit	<u>10 000</u>

⁵⁹ See ‘Framework for the Preparation and Presentation of Financial Statements’ (updated to January 2006) approved by the IASB in para 49.

⁶⁰ In para 65 of the Framework.

From a group perspective, Subco has transferred R50 000 of its reserves to Holdco. After the cancellation of its shares, Holdco’s reserves have increased by a net R10 000, being the remaining portion of the reserves received from Subco. From a group perspective the R10 000 has already been subjected to STC in Subco and should be allowed to flow upwards through the group free of STC. This result is achieved by means of the R10 000 STC credit that is available to Holdco.

Cancellation of shares as a result of a reconstruction of capital

The reconstruction of a company’s capital involves a drastic change in the share capital of a company that results in the cancellation of a shareholder’s shares in return for the receipt of cash or assets from the company in which the shareholder held those shares.

Paragraph (c) only applies to amounts distributed by the company, and not to amounts given to a shareholder by a third party as part of the reconstruction. Third party consideration does not constitute a ‘distribution’.

Paragraph (c) must be read with paras (iiA) and (iiB) of the first proviso, which ensure that any capitalised reserves previously forming part of any cancelled shares are carried across to any new class of shares issued by the company in substitution of those cancelled shares.

Example 7 – Reconstruction: Receipt of cash in exchange for cancellation of old shares

Facts:

John holds 500 shares of R1 each, giving a nominal value of R500. The nominal value of the company’s share capital does not include any capitalised reserves.

Under a company reconstruction, John’s shares are cancelled and he receives cash of R1 200 in return.

Result:

Under para (c) of the definition of a ‘dividend’, the company is regarded as having declared a dividend of R700, made up as follows:

	R
Cash received	1 200
Less: Nominal value of cancelled shares	<u>(500)</u>
Dividend under para (c)	<u>700</u>

Example 8 – Reconstruction: Receipt of new shares plus cash and assets in exchange for cancellation of old shares

Facts:

Sandra owns 100 shares of R1 each in A Ltd. These shares do not include any capitalised reserves. Under a reconstruction scheme Sandra’s old shares are cancelled and she receives the following in return:

- Cash of R200.
- Shares in B Ltd with a market value of R500.

- 100 class ‘C’ equity shares in A Ltd with a nominal value of R3 per share. These shares were paid up out of the reserve created when her old shares were cancelled (R100) and out of undistributed profits (R200).

Result:

The amount included as a dividend under para (d) is as follows:

	R
Cash	200
Shares in B Ltd	500
Class ‘C’ shares in A Ltd	<u>300</u>
Amount given to shareholder	1 000
Less: Nominal value of cancelled shares	<u>(100)</u>
Dividend under para (c)	<u>900</u>

However, R200 of the above amount represented by the portion of the ‘C’ shares paid up out of undistributed profits will be excluded as a dividend under para (h). The dividend therefore amounts to R900 – R200 = R700.

Example 9 – Reconstruction: Nominal value includes capitalised reserves

Facts:

ABC (Pty) Ltd’s share capital consists of shares of no par value. Jane holds shares with a nominal value of R500 made up as follows:

	R
Cash paid upon subscription of initial share issue	300
Profits transferred to stated capital account under s 75(1)(b) of the Companies Act	<u>200</u>
Stated capital (nominal value)	<u>500</u>

Under a company reconstruction scheme, Jane receives from ABC (Pty) Ltd shares in XYZ Ltd with a market value of R1 200 in exchange for the cancellation of her ABC (Pty) Ltd shares.

Result:

The company has declared a dividend as follows:

	R
Market value of XYZ Ltd shares	1 200
Less: Nominal value of old shares	<u>(500)</u>
Dividend under para (c)	<u>700</u>

As the nominal value of the ABC shares includes capitalised reserves, para (iii) of the first proviso applies, and the capitalised reserves of R200 are also deemed to be a dividend. Thus the total dividend declared is R700 + R200 = R900.

Example 10 – Reconstruction: Application of para (iiA) of the first proviso to the definition of a ‘dividend’

Facts:

A company’s issued share capital is made up as follows:

	R
400 shares of R1 each (originally subscribed for in cash)	400
<u>600</u> capitalisation shares of R1 each	<u>600</u>
<u>1 000</u>	<u>1 000</u>

The company’s share capital is reconstructed as follows:

- The existing 1 000 shares of R1 each are cancelled.
- 3 000 new shares of R2 each are awarded to the existing shareholders as compensation (market value R6 000).
- A further 2 000 new shares of R2 each are issued at par to a new shareholder.

The company’s share capital after reconstruction therefore consists of 5 000 shares of R2 each.

Result:

Since the company’s profits have not been reduced as a result of the cancellation of the A Ltd shares there is no dividend under para (c).

Note: The deemed available profits of R600 included in the nominal value of the old shares are not taken into account. Under para (iiA) of the first proviso they will attach to the 5 000 new shares,

If a portion of the share capital in respect of the 5 000 shares in issue after reconstruction is subsequently returned to shareholders, the share capital returned will be treated as a dividend under para (iii) or possibly under para (v) of the first proviso.

In the above example there is no cash payment to shareholders. In the event of a cash payment being made, para (iii) of the first proviso to the definition will also apply if there are deemed available profits.

2.7 Inclusions – Cancellation of shares of holding company held by subsidiary (para (cB))

Paragraph (cB) of the definition of a ‘dividend’ includes in the ‘amount distributed’

‘any reduction of the profits of a company, if—

- (i) that company holds shares in any other company which is a shareholder in relation to that company; and
- (ii) those shares are cancelled’.

Paragraph (cB) deals with a cross-holding situation in which one of the companies cancels its shares without paying any compensation or for a consideration which is less than the cost of those shares to the other company. Under these circumstances the holder of the shares will suffer a reduction in profits as a result of the loss on disposal of the shares.

Example – Cancellation without compensation of holding company shares held by subsidiary

Facts:

Holdco owns all the shares in Subco. Subco buys 100 000 shares in Holdco on the open market at a cost of R1 million. The shares have a nominal value of R1 each. Subsequently Holdco, with the consent of Subco, cancels these shares for no consideration.

Result:

Upon the cancellation of the Holdco shares, Subco writes off its investment in Holdco. This results in a reduction in Subco’s profits of R1 million which is treated as a dividend distributed by Subco under para (cB) of the definition of a ‘dividend’.

Upon cancelling the shares, Holdco transferred an amount of R100 000 from its share capital account to a special reserve fund.

2.8 Exclusions – Issue of capitalisation shares out of the share premium account (para (e))

Under para (e) of the definition of ‘dividend’ the term ‘amount distributed’ does not include

‘the nominal value of any capitalization shares awarded to a shareholder to the extent to which such shares have been paid up by means of the application of the whole or any portion of the share premium account of a company.’.

This exclusion was inserted as a result of the decision in *Dibowitz v CIR*.⁶¹ In that case the company had issued capitalisation shares out of its share premium account (£359 723) and out of retained income (£60 277), totaling £420 000. The definition of ‘dividend’ as it then read included ‘the nominal value of any bonus shares . . . awarded to the shareholders’. The court held that the entire sum of £420 000 was a dividend and that the phrase was an enlargement without qualification of the normal meaning of bonus shares and included all bonus shares awarded whatever the nature of the funds so capitalised.

If a company has transferred retained income to its share premium account, and then issues capitalisation shares out of that account, para (i) of the first proviso to the definition of a ‘dividend’ ensures that the profits so transferred remain available for distribution should the company’s share capital be subsequently reduced, redeemed or bought back.

Although para (h) of the definition of a ‘dividend’ excludes equity capitalisation shares, para (e) is still necessary to cater for non-equity capitalisation shares.

Example – Capitalisation shares issued out of ‘pure’ share premium

Facts:

ABC (Pty) Ltd’s capital employed was as follows:

	R
Share capital 100 shares of R1 each	100
Share premium	1 000
Retained income	100 000

The company issued 1 000 capitalisation shares of R1 each out of the share premium account to the holders of non-equity shares.

Result:

Although the nominal value of capitalisation shares is included as a dividend under para (b) of the definition of ‘dividend’, para (e) of the definition excludes capitalisation shares issued out of the share premium account. The 1 000 capitalisation shares are therefore not a dividend.

⁶¹ 1952 (1) SA 55 (A), 18 SATC 11.

2.9 Exclusions – Reduction of the share premium account (para (f))

Under para (f) of the definition of ‘dividend’ the term ‘amount distributed’ does not include

‘subject to the provisions of the first proviso to this definition, any distribution to the extent that it represents a reduction of the share capital or share premium account of a company’.

The rationale behind this exclusion is that share premium is similar to share capital and should not be treated as a dividend. See in this regard s 76(1) of the Companies Act, which, subject to the exceptions in that section, treats the share premium account as if it were paid up share capital.

If the share capital or share premium account includes capitalised reserves, and there is a repayment of share premium, para (f) will be overridden by para (i) read with para (iii) of the first proviso. The latter provisions ensure that any reduction in the share premium account is treated as a dividend to the extent of the capitalised reserves. See **2.18**.

Example 1 – Repayment of share premium account

Facts:

ABC (Pty) Ltd’s balance sheet appeared as follows:

	R
Share capital (1 000 shares of R1 each)	1 000
Share premium	1 000
Retained income	<u>1 000</u>
	<u>3 000</u>
Cash	<u>3 000</u>

The company repaid the share premium account to its shareholders. The share premium account was made up of the original premium on issue of the company’s shares, and contained no capitalised reserves.

Result:

The return of share premium is deemed not to be a dividend under para (f) of the definition of ‘dividend’.

Example 2 – Use of the share premium account to buy back shares

Facts:

The facts are the same as in Example 1 except that the company buys back 10% of its shares at R3 a share. For this purpose the company used its share premium account to the maximum extent possible.

Result:

The company has purchased 100 shares at a price of R3 per share = R300. The share capital is reduced by R100 (10% x R1 000) and the balance of R200 is paid out of the share premium account. Under para (f) the repayment of the share premium account R200 is excluded as a dividend. The first proviso does not apply because no part of the share premium account contains capitalised reserves.

2.10 Exclusions – Pre-acquisition dividends (para (g))

Under para (g) of the definition of ‘dividend’ the term ‘amount distributed’ does not include

‘any amount distributed by a company to a shareholder where the company and the shareholder form part of the same group of companies as defined in section 41, to the extent that the shareholder reduces the cost of the shares held in the company in accordance with generally accepted accounting practice as a result of the distribution’.

The exclusion applies to companies that form part of a ‘group of companies’ as defined in s 41. The definition of a ‘group of companies’ in s 41 is more restrictive than the definition of the same term in s 1. For example, the s 41 definition excludes non-resident companies and tax-exempt companies. The restricted definition is used in order to protect the tax base. The principle is that either the subsidiary must pay STC on an outgoing dividend or its holding company must pay CGT on a part-disposal of the shares it holds in the subsidiary.

The portion of the distribution that is exempt under para (g) will be a capital distribution under para 76(1)(c) of the Eighth Schedule and will trigger part-disposal in the holding company of the subsidiary’s shares under para 76A of the Eighth Schedule. Had the wider definition of a group in s 1 been used, a South African subsidiary would be exempt from STC on a pre-acquisition dividend, while a non-resident holding company or resident tax-exempt holding company would have no South African CGT consequences.

Before it was amended in May 2008, effective 1 January 2009, IAS 18 ‘Revenue’, provided as follows:

‘When dividends on equity securities are declared from pre-acquisition profits, those dividends are deducted from the cost of the securities. If it is difficult to make such an allocation except on an arbitrary basis, dividends are recognised as revenue unless they clearly represent a recovery of part of the cost of the equity securities.’

Paragraph (g) of the definition of a ‘dividend’ was based on the above requirement.

However, the accounting standards no longer treat pre-acquisition dividends in this manner.

IAS 27 ‘Consolidated and Separate Financial Statements’ (Issued January 2009) provides the rules on how an investment in a subsidiary must be recognised. It provides as follows:

‘38 When an entity prepares separate financial statements, it shall account for investments in subsidiaries, jointly controlled entities and associates either:

(a) at cost, or

(b) in accordance with IAS 39.⁶²

...

‘38A An entity shall recognise a dividend from a subsidiary, jointly controlled entity or associate in profit or loss in its separate financial statements when its right to receive the dividend is established.’

Under IAS 18⁶³

‘dividends shall be recognised when the shareholder’s right to receive payment is established’.

IAS 18 therefore no longer draws a distinction between pre- and post-acquisition dividends.

⁶² IAS 39 ‘Financial Instruments: Recognition and Measurement’ (Issued January 2009) in paras 43 to 70 which deal with measurement.

⁶³ Paragraph 30(c).

Under IAS 36 ‘Impairment of Assets’ (issued January 2009) a company is now required to test its investment in a subsidiary for impairment when dividends are received under specified circumstances.⁶⁴ In this regard IAS 36 states the following:

‘12 In assessing whether there is any indication that an asset may be impaired, an entity shall consider, as a minimum, the following indications:

...

- (h) for an investment in a subsidiary, jointly controlled entity or associate, the investor recognises a dividend from the investment and evidence is available that:
 - (i) the carrying amount of the investment in the separate financial statements exceeds the carrying amounts in the consolidated financial statements of the investee’s net assets, including associated goodwill; or
 - (ii) the dividend exceeds the total comprehensive income of the subsidiary, jointly controlled entity or associate in the period the dividend is declared.’

Paragraph (g) of the definition of a ‘dividend’ applies when the cost of the investment in a subsidiary is reduced under GAAP ‘as a result of’ a distribution from the subsidiary. The words ‘as a result of’ imply a causal link between the reduction in cost and the dividend. Should the cost of the investment be written down as a result of the receipt of a pre-acquisition dividend, the amount will to that extent be excluded as a dividend under para (g).

The change in accounting treatment of pre-acquisition dividends may, however, have different fiscal consequences from the previous GAAP. This is because a write down of cost will only occur under current GAAP when the investment’s fair value is impaired. In other words, even if a dividend is declared out of pre-acquisition profits it does not automatically follow that this will result in an impairment of the carrying value of the investment. There may be sufficient post-acquisition reserves in the subsidiary to maintain the value of the investment above cost, or the shares may trade at a value above the company’s net asset value. Assuming that the fair value of a company’s shares reflects net asset value, it is only when all post-acquisition reserves are exhausted and the subsidiary digs into its pre-acquisition profits that the dividend will result in impairment in value. Under old GAAP the investment would have been written down if the dividend came out of pre-acquisition profits, notwithstanding that the shares were still worth more than their cost price after receipt of the dividend.

The issue arises as to how para (g) is to be applied when a holding company accounts for its investment in its subsidiary at fair value under IAS 39. Effect must be given to the purpose of the legislature. It is accordingly considered that para (g) would apply if the carrying value (fair value) of the investment was written down below cost as a result of the receipt of a pre-acquisition dividend. In other words, the mere fact that the company has accounted for its investment at market value does not mean that the cost of the investment can be disregarded, and para (g) can still apply.

Example – Exclusion of pre-acquisition dividends

Facts:

Holdco, a resident, acquired all the shares in Subco, a resident, at a cost of R100 100 when Subco’s balance sheet appeared as follows:

R

⁶⁴ Paragraph 12(h).

Share capital	100
Retained income	<u>100 000</u>
	<u>100 100</u>
Assets	<u>100 100</u>

A year later when Subco’s retained income had increased to R150 000, Subco declared a dividend of R60 000 to Holdco. Subco’s board of directors stipulates in the resolution approving the dividend that it is as far as possible to be paid out of current profits. Holdco reflected the dividend of R60 000 as a dividend received in its income statement and wrote down the cost of its investment in Subco by R10 000.

Investment in Subco at cost	100 100
Fair value of Subco after distribution (R150 100 – R60 000)	<u>(90 100)</u>
Impairment in carrying value	<u>10 000</u>

Result:

Holdco and Subco are members of the same group of companies as defined in s 41. Under para (g) of the definition of ‘dividend’ R10 000 of the amount distributed is excluded as a dividend. Subco will therefore be liable to STC on a dividend of R50 000. For CGT purposes Holdco is treated as having received a capital distribution under para 76(1)(c) which triggers part-disposal treatment under para 76A of the Eighth Schedule.

2.11 Exclusions – Award of equity capitalisation shares (para (h))

Under para (h) of the definition of ‘dividend’ the ‘amount distributed’ does not include

‘the nominal value of any capitalization shares awarded to shareholders as part of the equity share capital of a company’.

This is the second and most important exclusion pertaining to capitalisation shares, the other being para (e) – capitalisation shares distributed out of the share premium account (see **2.8**).

While the nominal value of all capitalisation shares is included as dividends under para (b), the vast majority in practice are excluded under para (h), namely, those forming part of the equity share capital of the company. What this means is that capitalisation shares awarded that do not form part of the equity share capital of a company will constitute a dividend. However, capitalisation share awards that are dividends are fairly rare, no doubt because of the STC implications. The term ‘equity share capital’ is defined in s 1 as follows:

“[E]quity share capital” means, in relation to any company, its issued share capital and in relation to a close corporation, its members’ interest, excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution, and the expression “equity shares” shall be construed accordingly.’

In other words, if the right to share in both dividends and capital is restricted in any way, the share will not comprise an equity share. Some preference shares may nevertheless qualify as part of the equity share capital if, in addition to their preference rights they are entitled to participate in the balance of profits or capital to an unlimited extent. The use of the words ‘neither . . . nor’ also make it clear that both the right to dividends and capital must be restricted before a share will cease to be an equity share. Thus if the right to dividends is restricted but the right to capital is unrestricted, the share will be an equity share. Deferred shares are also equity shares. While such shares generally only participate after dividends up to a certain amount have been paid on ordinary shares, their right to dividends beyond a certain limit is not usually restricted. Nevertheless, the question as to whether or not deferred

shares (or any other class of shares for that matter) are equity shares must be assessed at a relevant point in time when required, since such shares may not necessarily be equity shares from the outset. For example, deferred shares are often issued to shareholders in Black Economic Empowerment (‘BEE’) deals, under which such shares’ rights to profits and capital are fully restricted until such time as the purchase consideration is fully settled by the BEE partner.

Example 1 – Capitalisation shares

Facts:

Listco issued 1 000 000 ordinary shares of R1 each by transferring the following amounts to its share capital account:

	R
Share premium account	250 000
Capital profit on sale of land	250 000
Revenue reserves	<u>500 000</u>
	<u>1 000 000</u>

Result:

The newly issued shares are capitalisation shares as defined in s 1. Although these shares fall within para (b) of the definition of ‘dividend’ they are excluded by para (h) of the definition, since their ‘nominal value’ forms part of the company’s equity share capital.

Example 2 – Capitalisation share constituting a dividend

Facts:

The ABC Bank Ltd issued 1 000 000 10% cumulative non-participating non-redeemable preference shares on 1 January 2005 at par value of R1 per share. The company’s articles provide that it is entitled to award capitalisation shares in lieu of dividends, and on liquidation the preference shareholders are limited to a return of the par value of their shares plus any unpaid dividends. On 31 December 2005 the bank awarded preference shareholders 1 capitalisation preference share with a par value of R1 for every 10 shares held in lieu of dividends as the bank was experiencing a cash flow crisis.

Result:

The capitalisation shares constitute a dividend because the right to participate in dividends is limited to 10% and the right to participate in capital on liquidation is limited to par value.

2.12 Exclusions – Distributions by co-operatives (para (i))

Under para (i) of the definition of ‘dividend’ the ‘amount distributed’ does not include

‘any amount distributed by a co-operative by way of a bonus, to the extent that such amount is allowable as a deduction from the income of such co-operative under the provisions of section 27’.

This exclusion is based on the principle that amounts paid to shareholders that are allowable as a deduction in the co-operative should be taxed as income in the hands of the shareholders. By not constituting a dividend received, the amount will not qualify for exemption under s 10(1)(k).

2.13 Exclusions – Redemption of interest in foreign collective investment scheme (para (j))

Under para (j) of the definition of ‘dividend’ the ‘amount distributed’ does not include

‘any amount distributed by way of the redemption of a participatory interest in a portfolio, arrangement or scheme contemplated in paragraph (e) of the definition of “company”’.

Paragraph (e) of the definition of a ‘company’ in s 1 includes in the definition

‘any—

(i) deleted

(ii) arrangement or scheme carried on outside the Republic in pursuance of which members of the public (as defined in section 1 of the Collective Investment Schemes Control Act, 2002 (Act No. 45 of 2002)), are invited or permitted to invest in a portfolio of a collective investment scheme, where one or more investors contribute to and hold a participatory interest in a portfolio of the scheme through shares, units or any other form of participatory interest.’

This exclusion, which was previously in para (c), was introduced to ensure consistency in the treatment of foreign collective investment schemes. In some schemes investors dispose of their interests to third parties or management companies thereby triggering a capital gain or loss (unless the interests are held as trading stock). In other schemes investors are obliged to redeem their interests, and this used to result in normal tax consequences in respect of the fully taxable deemed foreign dividend. With effect from years of assessment commencing on or after 1 January 2007 para (c) was amended to exclude interests in collective investment schemes. This means that in the case of a foreign collective investment scheme, unless such interests are held as trading stock, any redemption will trigger a capital gain or loss instead of a fully taxable foreign dividend. The exclusion under para (j) was inserted by s 5(1)(m) of the Revenue Laws Amendment Act 35 of 2007, deemed to have come into operation on 1 October, 2007 and applies in respect of any amount distributed on or after that date.

2.14 First proviso – Transfer of reserves to share capital or share premium account (para (i))

Paragraph (i) of the first proviso to the definition of a ‘dividend’ applies when on or after 1 January 1974 a company has transferred any amount from its reserves or undistributed profits to its share capital or share premium account. It includes the following types of transfers:

- Transfers that do not result in the paying up of capitalisation shares. For example, a simple transfer to the share premium account, or a transfer to the stated capital account in the case of no par value shares.⁶⁵
- Transfers which result in the paying up of capitalisation shares the nominal value of which, in whole or in part, do not comprise an amount distributed under the inclusion in para (b) read with the exclusions in paras (e) and (h). In other words, this includes equity capitalisation shares excluded as a dividend on issue under para (h). It excludes non-equity capitalisation shares that would have comprised a dividend upon issue.

⁶⁵ In terms of s 75(1)(b) of the Companies Act a company can ‘increase its share capital constituted by shares of no par value by transferring reserves or profits to the stated capital, with or without a distribution of shares’.

For the purpose of the above, the transfer of an amount from the share premium account to the share capital account is not regarded as a transfer of reserves.

The reference in para (i) to ‘share capital’ includes a company’s share capital consisting of shares of no par value, and hence to the ‘stated capital account’ referred to in s 77(1) of the Companies Act.

After transfer, the profits so transferred

- are deemed to be profits available for distribution, and
- retain their nature as capital or revenue profits respectively.

The purpose of this proviso is to ensure that distributable reserves retain their character as such despite being transferred to share capital or share premium.⁶⁶ The proviso becomes of relevance when a company returns part of its share capital or share premium to its shareholders by way of a share capital or share premium reduction or share buy-back. Without para (i) of the first proviso companies could argue that payments out of share capital are not a dividend under company law principles, or that payments out of share premium are excluded as dividends under para (f).

Given that para (i) of the first proviso has been in existence for decades, it is almost inconceivable that a company would contend in 2005 that a return of ‘tainted’ share capital was not a dividend. Yet this happened in ITC 1781,⁶⁷ in which a wholly owned subsidiary company declared a dividend to its holding company claiming exemption from STC under s 64B(5)(f). The holding company subsequently transferred the incoming dividend to its share capital and share premium account by way of journal entry. Upon its voluntary liquidation the holding company contended that the return of the capitalised dividend formed part of the company’s capital and was exempt from STC under s 64B(5)(c). The court dismissed the appeal, holding that the incoming going concern dividend had retained its character of a revenue nature, despite being journalised and being made temporarily part of capital. The case was taken on appeal in *Liberty Investors Ltd (In Members’ Voluntary Liquidation) v C: SARS*.⁶⁸ The SCA dismissed the appeal on the grounds that para (i) of the first proviso to the definition of ‘dividend’ deemed the amount to be a profit of a revenue nature available for distribution to shareholders. Both the Tax Court and counsel for the appellant had overlooked the proviso.

2.15 First proviso – Apportionment of capital and revenue profits between different classes of shares (para (ii))

Paragraph (ii) of the first proviso applies when

- under para (i) of the first proviso, capital or revenue profits have been transferred to the share capital or share premium account, and
- the company has different classes of shares.

In such event, the profits of a capital or revenue nature so transferred must be allocated across the different classes of shares in accordance with the respective rights of participation in such profits.

This proviso would apply, for example, when a company has equity shares and preference shares. A transfer of profits to share capital will usually not be for the benefit of preference

⁶⁶ In *CIR v Collins* 1923 AD 347, 32 SATC 211 it was held that when profits are capitalized through the issue of capitalization shares they take on the character of capital and cease to be divisible profits.

⁶⁷ (2003) 66 SATC 363 (G).

⁶⁸ 2006 (2) SA 1 (SCA), 67 SATC 313.

shareholders. In such a case the amount transferred will be apportioned to the equity share capital and in the event of a redemption of the preference shares the preference shareholders will not be regarded as having received any dividend out of deemed available profits as they are not entitled to participate therein by way of a return of share capital. This is of importance in determining incoming dividends in the hands of a particular shareholder for STC purposes.

2.16 First proviso – Conversion of shares to another class of shares (para (iiA))

This proviso applies when

- profits of a capital or revenue nature have been transferred to share capital or share premium (that is, para (i) of the first proviso applies),
- those profits have been allocated to different classes of shares under para (ii) of the first proviso,
- existing shares are converted to shares of another class, or
- the original shares are cancelled and replaced with shares of any other class.

In the above circumstances

- any profit allocated to the original shares is deemed to be a profit available for distribution in respect of the new class of shares (that is, para (i) of the first proviso continues to apply), and
- the holder of the new shares is deemed to be entitled to participate in the profits so allocated, regardless of the actual rights attaching to the new shares.

Example – Conversion of share capital into different classes of shares and subsequent redemption (para (iiA) of the first proviso)

Facts:

A company’s share capital appears as follows in its balance sheet:

Share capital	R
100 ordinary shares of R1 each	100
4900 ordinary capitalisation shares of R1 each	<u>4 900</u>
	<u>5 000</u>

The capitalisation shares were issued out of revenue reserves.

The company subsequently converted 4 900 of its ordinary shares into non-cumulative redeemable preference shares of R1 each. Later the preference shares are redeemed at par.

Result:

Originally the R4 900 deemed available revenue profits attached only to the 5 000 ordinary shares. Under para (iiA) the deemed available profits must be apportioned to the different classes of shares as follows:

100 Ordinary shares $R100/R5\ 000 \times R4\ 900 = R98$

4900 Preference shares $R4\ 900/R5\ 000 \times R4\ 900 = R4\ 802$.

On the redemption of the preference shares R4 802 is treated as a dividend under para (iii) of the first proviso to the definition of ‘dividend’. The balance of the deemed available profits, that is, R98 is apportioned to the remaining 100 ordinary shares.

2.17 First proviso – Cancellation of shares without return of share capital or share premium (para (iiB))

It is possible under s 311 of the Companies Act for a company to arrange for the transfer of assets to its shareholders or to another company or for a reduction of a company’s share capital without the necessity for a formal resolution placing the company in liquidation or reducing its share capital. Arrangements made under the said section have to be sanctioned by an order of court.

This proviso is subject to paras (iiA) and (iv) of the first proviso.

Paragraph (iiB) applies when

- an amount has been deemed to be a profit available for distribution to shareholders under para (i), or as applied by para (ii) of the first proviso (that is, reserves have been transferred to share capital or share premium), and
- shares issued by the company have been cancelled without a return of share capital or any share premium relating to those shares.

After the cancellation

- the cancelled share capital and related share premium (including capitalised profits) may be transferred to a newly created reserve, and
- shareholders may be or may become interested in the cancelled share capital, share premium, or reserve.

Any capitalised profits must be apportioned between

- the cancelled shares and their related share premium, and
- the shares that have not been cancelled and their related share premium.

The profit so apportioned is deemed to retain its capital or revenue nature.

The resulting share capital, share premium or reserve may be returned or distributed to shareholders in the form of cash or assets.

The amount of cash and value of assets returned to shareholders is deemed to be a dividend to the extent of the deemed profit available for distribution. The dividend would arise on distribution under para (a) of the definition of ‘dividend’ if the company is being wound up, liquidated, deregistered, or finally terminated, or under para (b) of the same definition when para (a) does not apply.

Example – Application of para (iiB) of the first proviso: shares cancelled without compensation

Facts:

A Ltd’s share capital in its balance sheet initially appeared as follows:

Share capital	R
8 000 000 ordinary shares of R1 each	8 000 000
2 000 000 ordinary capitalisation shares of R1 each	<u>2 000 000</u>
	<u>10 000 000</u>

The capitalisation shares were issued after 1 January 1974 out of the company’s revenue reserves.

Under a scheme of arrangement sanctioned by a court order 9,9 m of the company’s issued shares were cancelled. The R9,9 m share capital was not returned but transferred to a special reserve fund. The remaining 0,1 m shares are all held by a company, X Ltd, and the holders of 9,9 m cancelled shares were given shares of equivalent value in X Ltd. After the arrangement, A Ltd’s balance sheet appeared as follows:

Share capital	R
100 000 ordinary shares of R1 each	100 000
Special reserve fund	<u>9 900 000</u>
	<u>10 000 000</u>

Still later, A Ltd made a distribution to its sole shareholder of

- R3 000 000 out of the special reserve fund, and
- R50 000 by way of a return of a portion of the remaining share capital.

Result:

Stage 1

Immediately before the scheme of arrangement becomes effective the company has an issued share capital of R10 000 000, divided into 10 000 000 shares of R1 each. Under para (i) of the first proviso to the definition of ‘dividend’ the company has R2 000 000 deemed available profits, apportionable to all the shares. The amount apportionable to each share is 20 cents (that is, R2 000 000/10 000 000).

Stage 2

Immediately after the scheme of arrangement has become effective the company has an issued share capital of R100 000 divided into 100 000 shares of R1 each. The deemed available profits of R2 000 000 are now apportioned as follows:

- R20 000 to the remaining 100 000 shares (20 cents per share), and
- R1 980 000 to the special reserve fund of R9 900 000.

Stage 3

The dividend paid to shareholders is as follows:

Payment out of the special reserve fund R1 980 000

(The payment made is R3 000 000 but as this exceeds the portion of the special reserve fund which is regarded as consisting of deemed available profits the dividend is restricted to that portion, that is, R1 980 000. The amount is a dividend under para (b) of the definition of ‘dividend’, read with para (iiB) of the first proviso to the definition)

Return of portion of remaining share capital R20 000

(R50 000 is returned, but the dividend may not exceed deemed available profits apportioned to the remaining share capital at Stage 2. The amount of R20 000 is a dividend under para (b) of the definition of ‘dividend’, read with para (iii) of the first proviso to the definition).

Total dividend R2 000 000

2.18 First proviso – Reduction, redemption, buy-back or reconstruction of share capital or share premium (para (iii))

This proviso applies when a company has

- capitalised capital or revenue profits to its share capital or share premium account under para (i) of the first proviso,
 - subsequently partially reduced or redeemed its share capital or share premium,
 - bought back its own shares under s 85 of the Companies Act, or
 - reconstructed its share capital, and
- as a result thereof, returned share capital or share premium to its shareholders by way of cash or assets.

A dividend arises to the extent of any capitalised capital or revenue profits residing in either the share capital or share premium account. It is important to note that the company does not have a right to elect which part of the share capital or share premium is being returned, that is, the ‘tainted’ part or the ‘pure’ part. The amount repaid is simply a dividend to the extent of any capitalised reserves.

A return by a company of a portion of its share premium account to its shareholders is a dividend to the extent of any profits that were previously transferred to either share capital or the share premium account. In other words, the share capital and share premium account are viewed as a single pool. This means that even though a company’s share premium account may consist exclusively of initially contributed (‘pure’) capital, it cannot contend that it is returning ‘pure’ share premium as long as it has capitalisation shares that were paid up out of profits that have not previously been deemed to be distributed.

An amount returned by way of an asset *in specie* is equal to the market value of the asset.

The capitalised capital or revenue profits available for distribution must be reduced by the amount returned to shareholders.

Example 1 – Buy-back of shares (para (c) and para (iii) of first proviso)

Facts:

ABC Ltd’s balance sheet appeared as follows:

Share capital	R
- 10 000 shares of R1 each (subscribed in cash)	10 000
- 10 000 shares of R1 each (capitalisation shares issued out of revenue reserves)	10 000
Share premium	
- premium on original cash subscription	10 000
- transfer from revenue reserves upon issue of capitalisation shares	5 000
Revenue reserves	<u>5 000</u>

	<u>40 000</u>
Assets	<u>40 000</u>

The company bought back 8 000 shares at R2 per share. In the resolution passed by the directors authorising the buy-back, it was stipulated that the premium above the nominal value of the shares was to be paid out of the portion of the share premium account that related to the shares originally subscribed for in cash.

Result:

The company has bought back 8 000 shares at R2 each = R16 000. Under para (i) of the first proviso it has deemed profits available for distribution as follows:

	R
10 000 capitalisation shares of R1 each	10 000
Revenue profits in share premium account	<u>5 000</u>
	<u>15 000</u>

Under para (iii) of the first proviso, R15 000 is a dividend while the balance is a return of ‘pure’ share premium.

Example 2 – Buy-back of no par value shares (para (c) and para (iii) of first proviso)

Facts:

A company’s balance sheet appears as follows:

Share capital	R
100 000 shares of no par value	100 000
Profits transferred to stated capital account under s 75(1)(b) of the Companies Act	<u>200 000</u>
Stated capital account	300 000
Retained income	<u>600 000</u>
	<u>900 000</u>
Assets	<u>900 000</u>

The company buys back 10% of its shares at a price of R9 per share.

Result:

The company has returned cash of 10 000 x R9 = R90 000 to its shareholders. Under para (c) R60 000 is a dividend as this is the amount by which the nominal value of the shares has been exceeded.

Under para (i)(bb) of the first proviso, when a company transfers revenue reserves to its share capital, the amount transferred is deemed to be a revenue profit available for distribution.

Next, para (iii)(aa) of the first proviso deems a further amount to be distributed because

- the company has bought back its own shares under s 85 of the Companies Act,
- it has returned a part of its share capital to its shareholders by way of cash or assets, and
- a part of the amount so returned represents a revenue profit available for distribution by virtue of para (i)(bb) of the first proviso.

- Since the company’s deemed available profits amount to R200 000, the balance of the amount returned to the shareholder of R30 000 is deemed to be a dividend. The company does not have the right to elect that the amount being returned should be drawn proportionately from the originally contributed share capital to the extent of R10 000 (R100 000 x 10%).

Example 3 – Reduction of ‘pure’ share premium account while having capitalisation shares

Facts:

ABC (Pty) Ltd’s balance sheet appeared as follows:

Share capital	R
50 000 shares of R1 each initially subscribed for in cash	50 000
20 000 capitalisation shares of R1 each, paid up out of profits	20 000
Share premium (originally contributed in cash)	<u>50 000</u>
	<u>120 000</u>
 Assets	 <u>120 000</u>

Having surplus cash available for distribution to shareholders, and hoping to avoid STC, the company decided to repay the share premium account to its shareholders.

Result:

Of the amount of R50 000 returned to shareholders, R20 000 comprises a dividend for the reasons that follow. Under para (i) of the first proviso the amount of R20 000 is deemed to be a profit available for distribution. Next, under para (iii) of the first proviso, as soon as the ‘share capital (including any share premium)’ is reduced, the amount returned is deemed to be a profit distributed to shareholders to the extent of the deemed available profits.

Example 4 – Partial reduction of capital combined with reconstruction (para (d) and paras (iii) and (iiA) of the first proviso)

Facts:

A company’s share capital comprises 10 000 ‘A’ shares of R2 each, made up as follows:

6 000 ‘A’ shares of R2 each = R12 000 – originally subscribed for in cash.

4 000 ‘A’ shares of R2 each = R8 000 – capitalisation shares paid up by transferring R8 000 from revenue reserves.

The company then undergoes a reconstruction under which the holders of the 10 000 shares (nominal value R20 000) receive cash of R7 000 plus 15 000 ‘B’ shares with a nominal value of R1 per share.

The ‘A’ shares are cancelled.

There has been a partial reduction in share capital as follows:

<i>Share capital before reconstruction:</i>	R
10 000 ‘A’ shares of R2 each	20 000
<i>Share capital after reconstruction:</i>	
15 000 ‘B’ shares of R1 each	(15 000)
Partial reduction	<u>5 000</u>

The amount of R7 000 cash given to the shareholders is, to the extent of R5 000, regarded as representing a return of share capital, but is deemed to be a dividend under para (iii) of the first proviso.

Paragraph (d) of the definition of ‘dividend’ also apply. The sum of the cash (R7 000) and the value of the ‘B’ shares (R15 000), that is, R22 000, exceeds the nominal value of the cancelled ‘A’ shares (R20 000) by R2 000 and the amount of R2 000 constitutes a dividend under para (d). The total dividend is thus R5 000 plus R2 000, that is, R7 000. The deemed available profits of R8 000 previously attaching to the ‘A’ shares are reduced by the amount of R5 000 and the balance of R3 000 remaining is regarded as attaching to the ‘B’ shares under para (iiA) of the first proviso. (The return of capital of R5 000 in respect of the ‘A’ shares is regarded as having been effected immediately before the issue of the ‘B’ shares in the place of the cancelled ‘A’ shares.)

Example 5 – Buy-back of shares when company has different classes of shares in issue and reserves are capitalised by issuing capitalisation shares to one class only

Facts:

C Ltd’s balance sheet appeared as follows:

Share capital	R
100 Class ‘A’ ordinary shares of R1 each	100
100 Class ‘N’ ordinary shares of R1 each	100
Share premium initially contributed in cash	<u>800</u>
	<u>1 000</u>
 Assets	 <u>1 000</u>

Both the ‘A’ and ‘N’ shares participate equally in profits, but the ‘N’ shares do not carry any voting rights. The ‘A’ shares include 50 capitalisation shares of R1 each that were paid up out of distributable profits. Under s 85 of the Companies Act, C Ltd acquired 10% of the ‘N’ shares at a price of R5 per share. It reduced the ‘N’ shares by R10 and its share premium account by R40.

Result:

The following amount is included as a dividend under para (c):

	R
Cash given to ‘N’ shareholders (10 X R5)	50
Less: Nominal value of ‘N’ shares acquired	(10)
Reduction in profits included as dividend under para (c)	40
Less: Share premium reduction excluded by para (f)	(40)
Dividend before application of para (iii)	<u>Nil</u>

The nominal value (R10) is excluded under para (c), and the amount by which the share premium is reduced (R40) is excluded by para (f).

Under para (i) of the first proviso an amount of R50, which arose as a result of issuing the 50 class ‘A’ capitalisation shares, is deemed to be a profit available for distribution.

Under para (iii) of the first proviso, should any cash or asset representing a return of either share capital or share premium be given to shareholders the amount deemed to be a profit available for distribution is deemed to be distributed. It follows that the full amount of R50 paid to the ‘N’ shareholders is deemed to be an amount distributed out of the capitalised profits. The fact that those profits initially related to the ‘A’ shares is irrelevant, since both the ‘A’ and ‘N’ shares are entitled to participate in the company’s profits.

2.19 First proviso – Excessive return of share capital or share premium to a class of shareholders (para (iiiA))

This rule was introduced because under para (f) of the definition of ‘dividend’ a return of ‘pure’ share capital or share premium is excluded as a dividend. This exclusion led to shareholders in a particular class ‘cashing out’ from a company without any adverse STC consequences for the company. This was achieved, for example, by diverting share premium contributed by another class of shareholders to the class of shareholders wishing to dispose of their interests in the company. Although such distributions will trigger part-disposal treatment under para 76A of the Eighth Schedule in the shareholders’ hands, not all shareholders are subject to CGT (for example, non-residents and exempt bodies such as pension funds).

Paragraph (iiiA) of the first proviso addresses this concern by overriding para (f). When a class of shareholders receives more ‘pure’ share capital or share premium than they contributed, the excess is deemed to be a dividend. The provision applies when a company has different classes of shareholders and

- reduces its share capital or share premium account, or
- acquires, cancels or redeems its own shares.

In these circumstances the company is deemed to have distributed profits to the class of shareholders whose share capital or share premium has been reduced, to the extent that the amount of the share capital or share premium so reduced exceeds the amount of share capital or share premium contributed by that class of shareholders.

Disproportionate distributions within a class of shareholders

According to *Henochsberg*⁶⁹ it is possible to make an unequal distribution to a shareholder under s 90 of the Companies Act. In this regard the authors state the following:

‘There is nothing in the section to suggest that any payment must be made to all shareholders, rather than only to one or some of them. It is submitted that provided the authority granted by the articles is wide enough, a payment may be made to one or more shareholders and not necessarily in proportion to their shareholding.’

The rule in para (iiiA) does not target disproportionate capital distributions within the same class of shareholders, although such an arrangement might be an impermissible avoidance arrangement under ss 80A to 80L.

Once para (iiiA) is applied, no consequent reduction is made to the company’s existing actual profits. Thus the benefit of any ‘pure’ share capital or share premium is permanently lost, which should act as a strong deterrent to such diversionary distributions. One

⁶⁹ P M Meskin, B Galgut, J A Kunst, P Delpont and Q Vorster *Henochsberg on the Companies Act* [CD-ROM] (My LexisNexis: September 2009) LexisNexis Butterworths Durban in the commentary on s 90 of the Companies Act, 1973.

consolation, however, is that a corporate recipient of such a dividend would be entitled to an STC credit.

Example – Award of share premium contributed by one class of shareholders to another class of shareholders (para (iiiA) of first proviso)

Facts:

ABC Ltd’s balance sheet appears as follows on 31 December 2009:

	R
Share capital – 100 000 ordinary shares of R1 each	100 000
Retained income	<u>900 000</u>
	<u>1 000 000</u>
Assets	<u>1 000 000</u>

On 1 January 2010 ABC Ltd issues 100 000 8% preference shares with a nominal value of R1 per share at a premium of R900 000.

On 31 January 2010 ABC Ltd distributed the share premium of R900 000 contributed by the preference shareholders to its ordinary shareholders.

Result:

Despite para (f) of the definition of ‘dividend’, under para (iiiA) of the first proviso ABC Ltd is deemed to have distributed a dividend as follows:

	R
Reduction in share premium contributed by preference shareholders	900 000
Less: Ordinary share capital	<u>(100 000)</u>
Profits deemed to be distributed to ordinary shareholders	<u>800 000</u>

Note: ABC Ltd’s profits available for distribution remain at R900 000 despite R800 000 of the ‘pure’ share premium having been deemed to be a dividend.

2.20 First proviso – Reduction of share capital or share premium as a result of losses (para (iv))

This proviso applies when

- a company has lost some of its share capital or share premium as a result of losses incurred,
- that share capital or share premium includes capitalised profits, and
- the share capital or share premium is partially reduced to take account of the losses.

When this happens, the losses must be set off against the capitalised profits in determining the amount available for distribution. If possible, and taking into account the rights of different classes of shareholders

- capital losses must be set off against capital profits, and
- revenue losses must be set off against revenue profits.

Example – Reduction of capitalised capital profits following loss of share capital (para (iv) of first proviso)*Facts:*

ABC (Pty) Ltd’s balance sheet initially reflected the following:

	R
Share capital 100 000 shares of R1 each	100 000
Retained income	<u>100 000</u>
	<u>200 000</u>
Assets	<u>200 000</u>

The share capital was comprised of

- shares initially subscribed for in cash – R50 000
- capitalisation shares paid up out of revenue profits – R30 000
- capitalisation shares paid up out of capital profits – R20 000

Following a number of years of adverse trading conditions the company’s balance sheet appeared as follows:

	R
Share capital	100 000
Accumulated loss	<u>(40 000)</u>
	<u>60 000</u>
Assets	<u>60 000</u>

The accumulated losses are of a revenue nature.

In order to absorb these losses the company reduced the nominal value of its shares from R1 per share to 60 cents per share, after which the balance sheet appeared as follows:

	R
Share capital 100 000 shares of 60 cents each	<u>60 000</u>
Assets	<u>60 000</u>

Under para (iv) of the first proviso the company’s capitalised profits available for distribution must be reduced as follows:

	Capitalised revenue profits	Capitalised capital profits	Total
	R	R	R
Capitalised profits before reduction	30 000	20 000	50 000
Less: Loss of capital	<u>(30 000)</u>	<u>(10 000)</u>	<u>(40 000)</u>
Available for distribution	<u> -</u>	<u>10 000</u>	<u>10 000</u>

The revenue loss is first set off against the capitalised revenue profits, and once those are exhausted, the balance is set off against the capitalised capital profits.

2.21 First proviso – Loss of share capital upon winding-up or liquidation (para (v))

Paragraph (v) of the first proviso is a difficult piece of legislation that is widely misunderstood. The difficulty in interpreting para (v) stems from the complex sentence construction of the 155-word para (v)(bb).

The purpose of para (v)

The first proviso is primarily aimed at ensuring that reserves retain their nature as profits available for distribution when transferred to the share capital or share premium account. This prevents profits from being disguised as share capital and ensures that they can be subjected to STC as a dividend in the event of a subsequent reduction or repayment of share capital. In the case of a company in liquidation, para (a) and para (i) of the first proviso ensure that such capitalised profits will be subject to STC when distributed to shareholders by the liquidator. It follows that para (v) is not needed to subject capitalised profits to STC. It is instead there to

- lay down rules for matching realised capital and revenue losses against capitalised capital and revenue profits (para (v)(aa)), and
- limit the amount of capitalised profits when assets are distributed *in specie* to shareholders and there are unrealised losses.

Paragraph (v)(aa) of the first proviso

Paragraph (v)(aa) provides that

‘in the event of the winding-up or liquidation of the company—

(aa) any profits which in terms of the preceding provisions of this proviso are, at the commencement of the winding-up or liquidation, deemed to be available for distribution to shareholders shall, if the company has lost some of its paid-up share capital (including any share premium) as a result of losses actually incurred by it, be deemed to have been reduced in such manner that, as far as possible and on the basis, where necessary, of an apportionment between different classes of share capital in accordance with the rights of shareholders—

- (A) any such profits which are of a capital nature and relate to shareholders entitled to participate in profits of that nature, are reduced by so much of the loss of the said share capital as is attributable to losses of a capital nature; and
- (B) any such profits which are not of a capital nature and relate to shareholders entitled to participate in profits which are not of a capital nature, are reduced by so much of the loss of the said share capital as is attributable to losses which are not of a capital nature; and

(bb) . . .’.

This paragraph applies when

- a company has lost some of its paid up share capital as a result of realised losses immediately before winding-up or liquidation, and
- the company’s share capital or share premium includes capitalised reserves.

When this happens

- capital losses must be matched against capitalised capital profits, and
- revenue losses must be matched against capitalised revenue profits.

Paragraph (v) only applies when a company is being wound up or liquidated. It does not apply to distributions in anticipation of liquidation, winding-up, deregistration or final termination of a company’s corporate existence.

In order for it to be said that the company has lost some of its share capital as a result of losses, the company must have an overall accumulated loss.

Example – Loss of share capital

Facts:

A company’s balance sheet before liquidation appears as follows:

<i>Capital employed</i>	<i>R</i>
Share capital (including capitalised reserves)	10 000
Capital profit	5 000
Revenue loss	<u>(8 000)</u>
	<u>7 000</u>
 <i>Employment of capital</i>	
Cash	<u>7 000</u>

Result:

Paragraph (v)(aa) of the first proviso applies, because the company has lost R3 000 of its share capital.

Although para (v)(aa) does not say so, it is accepted that when the capitalised capital profits are insufficient to absorb the realised capital losses, the excess must be applied against capitalised revenue profits. Similarly, when revenue losses exceed realised revenue profits, the excess must be allocated against capital profits.

Paragraph (v)(bb) of the first proviso

Paragraph (v)(bb) provides that

‘in the event of the winding-up or liquidation of the company—

(aa) . . . and

(bb) the aggregate of any cash and the value of any assets given to shareholders entitled to participate in profits not of a capital nature shall, to the extent that such aggregate exceeds so much of the sum of the share capital and any share premium contributed by such shareholders (less so much of such share capital and share premium as has been lost) as remains after deducting therefrom an amount equal to so much of any profits, not of a capital nature, which are deemed by this proviso (after applying subparagraph (aa) of this paragraph) to be available for distribution to such shareholders at the commencement of the winding-up or liquidation, as relates to the said share capital, be deemed to be a profit, not of a capital nature, distributed to such shareholders, but the amount of that profit shall not be determined at an amount which exceeds the aforesaid amount’.

Paragraph (v)(bb) of the first proviso is aimed at reducing the deemed capitalised revenue profits by net unrealised losses when assets are to be distributed *in specie* during winding-up or liquidation. The computation for this purpose may be summarised as follows:

Cash and assets given to shareholders entitled to participate in revenue profits		XXX
Less: Share capital (including capitalised profits) reduced by portion lost (1)	(XXX)	
Less: Share premium (including capitalised profits) reduced by portion lost	(XXX)	
Capitalised revenue profits less realised losses as determined under para (v)(aa) (2)	<u>XXX</u>	(XXX)
Deemed available capitalised revenue profits (3)		<u>XXX</u>

Notes:

(1) The proviso refers to share capital and any share premium ‘contributed by such shareholders’. This must be interpreted as including capitalised profits and not only the initial subscribed share capital. This is because the capitalised profits are deducted from the share capital or share premium (see (2) above). Furthermore, the reference is intended to cover the class of shareholders who are entitled to revenue profits rather than the actual shareholders who initially contributed.

(2) & (3) – If (3) exceeds (2) the capitalised profits will simply be equal to those determined under para (i) of the first proviso.

Example 1 – Unrealised capital loss on liquidation

Facts:

A company’s balance sheet appears as follows immediately before liquidation:

Capital employed

Share capital	R
Originally subscribed for in cash	50
Capitalisation shares	<u>50</u>
	<u>100</u>

Employment of capital

Asset (market value R70)	<u>100</u>
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Determine the deemed capitalised profits available for distribution.

Result:

	R	R
Market value of asset to be awarded to shareholder		70
Less: Share capital contributed	(100)	
Capitalised revenue profits	<u>50</u>	(50)
Deemed profits available for distribution		<u>20</u>

Proof:

Capitalised revenue profits		50
Less: Unrealised capital loss (R100 – R70)		(30)
Revised capitalised revenue profits available for distribution		<u>20</u>

Example 2 – Unrealised capital profit and realised capital loss on liquidation*Facts:*

A company's balance sheet appears as follows immediately before liquidation:

Share capital	R
Originally subscribed for in cash	50
Capitalisation shares (ex revenue profits)	<u>50</u>
	100
Accumulated revenue loss	<u>(20)</u>
	<u>80</u>
Asset (market value R120)	<u>80</u>

Determine the deemed capitalised profits available for distribution.

Result:

Step 1 – Determine revised capitalised profits by setting off realised losses (para (v)(aa))

	R	R
Capitalised revenue profits		50
Less: Realised revenue loss		<u>(20)</u>
Revised capitalised revenue profits		<u>30</u>

Step 2 – Determine revised capitalised revenue profits (para (v)(bb))

Market value of asset to be awarded to shareholder		120
Less:		
Share capital contributed less portion lost (R100 – R20)	(80)	
Revised capitalised revenue profits (per step 1)	<u>30</u>	<u>(50)</u>
Deemed profits available for distribution		<u>70</u>
Actual capitalised profits		<u>30</u>

In this example it was not actually necessary to apply para (v)(bb) because there were no unrealised capital or revenue losses. Since R70 exceeds R30, the capitalised profits will simply be equal to those determined under para (i) of the first proviso, namely, R30.

Example 3 – Application of para (v)(aa) and (bb)*Facts:*

At the commencement of liquidation, a company's assets and liabilities are as follows:

	R
Share capital contributed in cash	100
Share capital contributed by way of:	
- transfers ex revenue reserves	3 500
- transfers ex capital profits	500
Share premium contributed in cash	<u>900</u>
	5 000
Revenue reserves	2 000
Realised capital losses	<u>(3 000)</u>
Total capital employed	4 000
Creditors	<u>10 000</u>
	<u>14 000</u>

Cash			10 000
Securities at cost (market value R3 000)			<u>4 000</u>
			<u>14 000</u>
<i>Step 1: Allocate realised losses against capitalised profits</i>			
	Capitalised capital profits	Capitalised revenue profits	Revenue profits
	R	R	R
Profits	500	3 500	2 000
Allocate capital loss	<u>(500)</u>	<u>(500)</u>	<u>(2 000)</u>
Revised capitalised profits	<u>-</u>	<u>3 000</u>	<u>-</u>
<i>Step 2 – Determine revised capitalised revenue profits</i>			
			R
Cash			10 000
Market value of securities			3 000
Creditors			<u>(10 000)</u>
Amount returned to shareholders			3 000
<i>Less:</i>			
Share capital		4 100	
<i>Less: portion lost (R500 + R500)</i>		<u>(1 000)</u>	3 100
Share premium			900
<i>Less: Capitalised revenue profits (step 1)</i>			<u>(3 000)</u>
Revised capitalised revenue profits			<u>2 000</u>
<i>Proof:</i>			
Capitalised revenue profits			3 500
Realised revenue profits			2 000
<i>Less: Balance of realised capital losses (R3 000 – R500)</i>			<u>(2 500)</u>
Unrealised capital loss			<u>(1 000)</u>
Available for distribution			<u>2 000</u>

2.22 Second proviso – Amounts transferred from share premium account

The second proviso to the definition of a ‘dividend’ applies when a company has transferred an amount from its share premium account to a reserve.

For the purposes of the definition of ‘dividend’, any share premium included in that reserve will continue to retain its character as a share premium.

Example – Amount transferred from share premium account

Facts:

ABC (Pty) Ltd transferred R100 000 from its share premium account to a capital redemption reserve fund to be used for the purpose of redeeming its redeemable preference shares.

Result:

While the capital redemption reserve fund remains in existence, it will continue to be regarded as a share premium account for the purposes of the definition of ‘dividend’. To the extent that it is used to redeem the preference shares it will disappear and not constitute a dividend by virtue of para (f) read with the second proviso.

2.23 Third proviso – inclusion of unrealised profits

Before the insertion of the third proviso to the definition of a ‘dividend’ some commentators contended that unrealised profits associated with a dividend *in specie* were not subject to STC. This view was not accepted by SARS for the reasons set out in issue 2 of this guide. The introduction of the third proviso has put paid to the debate. It provides as follows:

‘Provided further that for the purposes of this definition “**profits**” includes realised and unrealised profits of a company whether or not those unrealised profits have been recognised in the financial records of the company.’

Thus an unrealised profit associated with a dividend *in specie* must be taken into account even if the company has not revalued the asset to market value in its books of account.

Generally accepted accounting practice

Under IFRIC 17 ‘Distributions of Non-cash Assets to Owners’ an entity should measure a dividend *in specie* payable at the fair value of the net assets to be distributed. The interpretation is effective for annual periods beginning on or after 1 July 2009.⁷⁰

Example – Distribution *in specie**Facts:*

Company X distributed an asset shown in its books of account at cost of R100 to its shareholder at a time when the market value of the asset was R150. Contrary to IFRIC 17 the company reflects the dividend in its financial statements at an amount of R100.

Result:

Under the third proviso to the definition of ‘dividend’ the amount of the dividend is deemed to be R150. The fact that Company X did not revalue the asset to its fair value before distributing it is irrelevant.

⁷⁰ See <<http://www.iasplus.com/interps/ifric017.htm>> [Accessed 21 September 2010].

Chapter 3 – Secondary Tax on Companies

3.1 Quick reference guide to s 64B of the Act

Table 1 – Quick reference guide to s 64B

Section 64B	Topic	Description
(1)	Definitions	'Declared', 'dividend cycle', 'group of companies', 'profit'.
(2)	Description, rate of tax and date from which applicable, method of determination, and application	STC = 10% x 'net amount' of dividends declared by any company which is a resident.
(3)	'Net amount'	Net amount = Dividends declared /less dividends accrued during the dividend cycle. If dividends accrued exceed dividend declared, the excess is deemed to be a dividend accrued in the next cycle. Previous incoming dividends exempt under s 64B(5)(c) are allowed as a deduction only when the recipient company is liquidated/deregistered/finally terminated.
(3A)	Dividends excluded as incoming dividends for purposes of determining 'net amount'	Incoming dividends do not include <ul style="list-style-type: none"> • those exempt under s 64B(5)(b) or (f) • those accruing to a borrower in respect of a share borrowed under a securities lending arrangement. • Any foreign dividend, subject to certain exceptions e.g. if paid out of dividends that were subject to STC or out of profits subject to tax at the higher normal tax rate applicable to companies that are not resident in South Africa.
(4)	Date of accrual	Dividends are deemed to accrue in the case of <ul style="list-style-type: none"> • dividends declared to shareholders registered on a certain date, on that date • interim dividends, on date of declaration • cash or assets distributed / transferred otherwise than by way of a formal dividend or by the liquidator of a company during the course of winding-up, the date on which the shareholders become entitled to the cash or assets.
(5)	Exempt dividends / persons	(a) Companies whose entire receipts and accruals are exempt from tax under s 10. Specifically included is a company whose receipts and accruals are exempt from tax under s 10 other than receipts and accruals from investments (for example, an approved recreational club). Excluded is any registered micro business under the Sixth Schedule. (b) Dividends claimed as a deduction under s 11(s)

		<p>by a fixed property company</p> <p>(c) Certain dividends declared during the course, or in anticipation of liquidation, winding-up, deregistration or final termination of a company.</p> <p>(d) Deleted</p> <p>(e) Dividends declared out of proceeds from the disposal of gold mining assets by a company that elected to be exempt from STC.</p> <p>(f) Dividends declared by a controlled company to a shareholder forming part of the same group of companies as defined in s 41. The shareholder must be subject to STC and the dividend must be taken into account in determining its profits. The relief requires an election by the distributing company, which must be submitted to SARS in the manner and within the time prescribed. Certain dividends distributed under a cross-holding situation are excluded from the exemption.</p> <p>(g) Deleted.</p> <p>(h) Deleted.</p> <p>(i) Dividends declared by a s 37H company within six months of the end of its tax holiday period out of profits derived during that period.</p> <p>(j) Deleted.</p> <p>(k) Distribution of an interest in a residence contemplated under para 51 of the Eighth Schedule.</p> <p>(l) A dividend declared by a registered micro business not exceeding R200 000 during the year of assessment.</p>
(6)	Deleted	
(7)	Payment of tax and submission of returns	<ul style="list-style-type: none"> • STC must be paid by the end of the month following the month in which the dividend cycle ends • The prescribed form (IT56 – Return for payment of STC) must accompany payments. • The Commissioner may extend the due date for payment.
(8)	Estimated assessments	The Commissioner may estimate an unpaid amount of STC and issue an assessment in respect thereof.
(9)	Interest on outstanding STC	Interest is payable at the prescribed rate on any outstanding STC from the end of the period concerned.
(10)	Deleted.	
(11)	Assessment, recovery and additional tax	The same provisions of the Act applicable to normal tax and additional tax apply to STC.
(12)	Election by gold mining	A company that

	company to be exempt from STC	<ul style="list-style-type: none"> • was carrying on gold mining on 17.3.1993 could elect by 31.8.1993 to be exempt from STC. • commences gold mining after 17.3.1993 may also make such an election within six months of such commencement. • The election is binding on all future dividends and applies to dividends from all profits (including non-gold mining profits). The elected exemption ceases with effect from the year subsequent to the year in which a company ceases to mine for gold.
(13)	Limitation of incoming dividends of long-term insurers	An insurer is only permitted to deduct incoming dividends derived from shares held as assets by its corporate fund. Dividends accruing on shares held by the other three funds are not allowed as incoming dividends.
(14)	Deleted.	
(15)	Deleted.	
(16)	Deleted.	
(17)	Deleted.	

3.2 Definition – ‘declared’ (s 64B(1))

“**[D]eclared**”, in relation to any dividend (including a dividend *in specie*), means the approval of the payment or distribution thereof by the directors of the company or by some other person under authority conferred by the memorandum and articles of association of the company or, in the case of the liquidation of a company, by the liquidator thereof;’

This definition regulates the timing of dividend declarations. The term ‘company’ is used in its defined sense and includes a close corporation.⁷¹ The term ‘director’ is also defined in s 1, and in the context of a close corporation means

‘any person who in respect of such close corporation holds any office or performs any functions similar to the office or functions of a director of a company other than a close corporation’.

3.3 Definition – ‘dividend cycle’ (s 64B(1))

“**[D]ividend cycle**” means—

- (a) in relation to the first dividend declared by a company (other than a company which carries on long-term insurance business) on or after 17 March 1993, the period commencing on the later of—
- (i) 1 September 1992;
 - (ii) the day following the date of declaration of the last dividend (other than a dividend *in specie* or a dividend payable on a preference share) declared by the company prior to 17 March 1993;
 - (iii) the date on which that company was incorporated, formed or otherwise established; and
 - (iv) the date on which that company becomes a resident,

⁷¹ Paragraph (f) of the definition of ‘company’ in s 1 includes a close corporation.

- and ending on the date on which such first dividend accrues to the shareholder concerned or on which the amount is deemed to have been declared as contemplated in section 64C(6);
- (aA) in relation to the first dividend declared by a company which carries on long-term insurance business out of profits derived during any year of assessment commencing on or after 1 July 1993, the period commencing on the later of—
- (i) the later date of the date on which that company was incorporated, formed or otherwise established or 1 July 1993; and
 - (ii) the day following the date of declaration of the last dividend (other than a dividend in specie or a dividend payable on a preference share) declared by the company prior to the declaration of the said first dividend,
- and ending on the date on which such first dividend accrues to the shareholder concerned or on which the amount is deemed to have been distributed as contemplated in section 64C(6); and
- (b) in relation to any subsequent dividend declared by that company, the period commencing immediately after the previous dividend cycle of the company and ending on the date on which such dividend accrues to the shareholder concerned or on which the amount is deemed to have been distributed as contemplated in section 64C(6).’

The dividend cycle represents the period in respect of which a company’s STC liability is determined. In other words, it is the equivalent of a ‘period of assessment’. The dividend cycle is not tied to a company’s year of assessment and only ends when and if a dividend is declared. The dividend cycle can therefore range from a few days to many years. The definition provides rules for determining when the dividend cycle begins and ends. Separate rules exist for the first dividend cycle of long-term insurers.

When does a dividend cycle begin and end?

Table 1 – When the dividend cycle begins and ends (companies other than long-term insurers)

Dividend cycle	Begins	Ends
First	<p>On the <i>later</i> of the following dates:</p> <ul style="list-style-type: none"> • 1 September 1992. • When a dividend (other than a dividend <i>in specie</i> or preference dividend) was declared after 1 September 1992 but before 17 March 1993, the day following the declaration. • The date of incorporation, formation or establishment of the company. • The date on which the company became a resident. 	<p>When</p> <ul style="list-style-type: none"> • the first dividend accrues to the shareholder concerned, or • the amount is deemed to be distributed under s 64C(6).
Subsequent	Immediately after the end of the previous dividend cycle.	<ul style="list-style-type: none"> • When the subsequent dividend declared accrues to the

		shareholder, or
		<ul style="list-style-type: none"> When the amount is deemed to have been distributed under s 64C(6).

Table 2 – When the dividend cycle begins and ends (long-term insurers)

Dividend cycle	Begins	Ends
First	<ul style="list-style-type: none"> In respect of a dividend ('the first dividend') declared out of profits derived during years of assessment commencing on or after 1 July 1993, on the later of 1 July 1993 or subsequent date of incorporation, formation or establishment. The day following the date of declaration of any dividend (other than a dividend <i>in specie</i> or preference dividend) declared before the first dividend. 	<ul style="list-style-type: none"> When the first dividend accrues to the shareholder concerned, or when the amount is deemed to be distributed under s 64C(6).
Subsequent	Immediately after the end of the previous dividend cycle.	<ul style="list-style-type: none"> When the subsequent dividend declared accrues to the shareholder, or When the amount is deemed to have been distributed under s 64C(6).

Section 64B(4) sets out when a 'dividend' as defined in s 1 is deemed to accrue to a shareholder. Section 64C(2) contains a list of events that are deemed to be dividends declared (for example, the granting of a loan to a shareholder). The timing of the events in s 64C(2) is set out in s 64C(6). These dates determine when the dividend cycle ends and when incoming dividends can be claimed as a credit for the purposes of determining the 'net amount'.

Examples – Dividend cycle

Facts (1):

Resident Company A was formed in June 1992 and declared dividends on 15 December 1993 and 15 December 1994. The dividends declared in 1993 and 1994 were payable to shareholders registered in the company's share register on 31 December 1993 and 31 December 1994 respectively.

Result (1):

The first dividend cycle commences on 1 September 1992 and ends on 31 December 1993. The next dividend cycle commences on 1 January 1994 and ends on 31 December 1994.

Facts (2):

Resident Company B was formed in 1990 and declared dividends on 15 June 1992 and 15 June 1995. The dividends were payable to shareholders registered in the company's share register on 30 June 1992 and 30 June 1995 respectively.

Result (2):

The first dividend cycle commences on 1 September 1992 and ends on 30 June 1995. The next dividend cycle commences on 1 July 1995.

Facts (3):

Foreign Company C was formed in 1990 and changed its place of effective management from the Isle of Man to South Africa on 30 June 2005. Thereafter it declared and paid a dividend on 31 July 2005.

Result (3):

The first dividend cycle commences on 30 June 2005 and ends on 31 July 2005. The next dividend cycle commences on 1 August 2005.

3.4 Definition – 'group of companies' (s 64B(1))

“**[G]roup of companies**” means “group of companies” as defined in section 41.’

The term ‘group of companies’ is defined in s 41 as follows:

“**[G]roup of companies**” means a group of companies as defined in section 1: Provided that for the purposes of this definition—

- (i) any company that would, but for the provisions of this definition, form part of a group of companies shall not form part of that group of companies if—
 - (aa) that company is a company contemplated in paragraph (c), (d) or (e) of the definition of “company”;
 - (bb) that company is a company contemplated in section 21 of the Companies Act, 1973 (Act No. 61 of 1973);
 - (cc) any amount constituting gross income of whatever nature would be exempt from tax in terms of section 10 were it to be received by or to accrue to that company;
 - (dd) that company is a public benefit organisation or recreational club that has been approved by the Commissioner in terms of section 30 or 30A; or
 - (ee) that company is a company contemplated in paragraph (b) of the definition of “company”, unless that company has its place of effective management in the Republic; and
- (ii) any share that would, but for the provisions of this definition, be an equity share shall be deemed not to be an equity share if—
 - (aa) that share is held as trading stock; or
 - (bb) any person is under a contractual obligation to sell or purchase that share, or has an option to sell or purchase that share unless that obligation or option provides for the sale or purchase of that share at its market value at the time of that sale or purchase;

For STC purposes the more narrow definition of a ‘group of companies’ in s 41 is used instead of the wider definition in s 1. The more narrow definition excludes, for example, non-resident companies and companies granted full or partially exempt status for income tax purposes.

3.5 Definition – ‘profit’ (s 64B(1))

“‘[P]rofit’ includes any amount deemed in terms of the definition of “dividend” in section 1 to be a profit available for distribution.’

This definition ensures that when profits have been transferred to the share capital or share premium account of a company, they will continue to be regarded as profits for STC purposes.

3.6 Application and rate (s 64B(2))

Section 64B(2) provides as follows:

- The tax is known as ‘the secondary tax on companies’.
- It is calculated at 10% of the ‘net amount’ of any dividend declared.⁷²
- The tax is only payable by a company that is a resident. A foreign company could be liable for STC if its place of effective management is in South Africa.
- The ‘net amount’ of dividends declared is determined under s 64B(3).

STC applies to any company that is a resident. The term ‘company’ is defined in s 1 and includes the entities set out in the table below.

Table 1 – Entities comprising companies under the definition of company in s 1

Paragraph of definition of company in s 1	Description	Comments
(a)	Association, corporation, company or body corporate formed under South African law.	Examples: A public or private company, a share block company as defined in s 1 of the Share Blocks Control Act 59 of 1980, or a body corporate established in terms of the Sectional Titles Act 95 of 1986.
(b)	Same as (a), but formed under foreign law.	Companies formed offshore will only be subject to STC if resident in South Africa. That could happen, for example, if the company were effectively managed in South Africa.
(c)	Any co-operative. ⁷³	Association of persons registered under the Co-

⁷² STC was payable before this date at different rates based on the ‘net amount’ of dividends declared (17 March 1993 to 21 June 1994 – 15%, 22 June 1994 to 13 March 1996 – 25%, 14 March 1996 to 30 September 2007 – 12,5%, 1 October 2007 to date – 10%).

⁷³ Inserted by s 3(1)(a) of the Revenue Laws Amendment Act 20 of 2006. The insertion was made merely to provide clarity (co-operatives were previously regarded as falling under para (d) of the definition of ‘company’).

		operatives Act, 1981.
(d)	Association formed for specified purpose to benefit the public or a section of the public.	Such a company would be exempt from STC in terms of s 64B(5)(a) if all its receipts and accruals are exempt from tax (e.g. under s 10(1)(d))
(e)(i)	Deleted	
(e)(ii)	Collective investment scheme carried on outside South Africa.	Such a company would not attract STC unless it was a South African resident (see notes on para (b) companies above).
(f)	Close corporation	Close corporation under the Close Corporations Act, 1984.

Backdating of dividend declarations

STC was introduced in 1993 and applied to any dividend *paid* on or after 17 March 1993. Many cases arose at this time when companies credited their shareholders' loan accounts with dividends, and the issue then arose as to whether the dividends had been paid before the implementation date. One such case was ITC 1688⁷⁴ in which the company had declared two dividends to its sole shareholder before 17 March 1993 but actual crediting of his loan account only took place on 31 July 1993. The court held that the determination of the date upon which payment was made was a question of fact. On a proper construction of the facts the payment of a dividend in each case was made on the date on which the respective resolutions were passed. The court accordingly held that the taxpayer company was not liable for STC on dividends declared by it in the relevant tax years.

In Special Board Decision 95⁷⁵ the company passed a resolution dated 1 March 1993 declaring all its reserves as a dividend. Based on the evidence it emerged that the resolution had actually been passed when the financial statements for the year ended 28 February 1994 were prepared. The Chairman noted that while there was some uncertainty with regard to fair presentation in financial statements, this did not imply a licence to deliberately record falsehoods.

Changes in rate

Under s 64B(2) the rate of STC is applied to the net amount of dividends *declared*. It follows that the rate is determined at the time of declaration, and not at the end of the dividend cycle when the outgoing dividend accrues to the shareholder. The word 'declared' is defined in s 64B(1) and in most cases will be the date when the dividend is approved for payment by the directors. Thus a dividend declared and approved for payment on 27 September 2007 that is payable to shareholders on 5 October 2007 will attract STC at the rate of 12,5% and not at the reduced rate of 10% applicable from 1 October 2007.

⁷⁴ (1999) 62 SATC 478 (N).

⁷⁵ SBD 95 (1998) 3 TBDR 54 (N).

3.7 The 'net amount' (s 64B(3))

The net amount is the amount by which the dividend declared by the company (the outgoing dividend) exceeds the sum of dividends accruing to the company (the incoming dividends) during the dividend cycle.

Example 1 – Determination of net amount

Facts:

ABC (Pty) Ltd's last dividend cycle ended on 1 March 2009 (that is, this was the last time it declared a dividend). On 28 February 2010 it declared a dividend of R100 000 which accrued to its shareholder on that date. During the period 2 March 2009 to 28 February 2010 dividends totalling R20 000 accrued to the company. Determine ABC (Pty) Ltd's STC liability.

Result:

	R
Outgoing dividend declared	100 000
Less: Incoming dividends accrued	<u>(20 000)</u>
Net amount	<u>80 000</u>

STC R80 000 x 10% = R8 000

10/100 or 10/110?

Under s 64B(2) STC is calculated at 10% of the 'net amount' (dividend declared less dividends accrued during the dividend cycle). Assuming for the sake of simplicity that there are no incoming dividends STC is therefore calculated at 10% of the *dividend declared*. The STC payable is not determined by using the fraction 10/110. The latter fraction is used to determine the STC payable assuming that all profits are declared by way of dividend except a portion retained to cover the STC. It is typically used when declaring a final dividend on liquidation or deregistration of a company, but could also be used in a going concern situation if it is desired to utilise all profits in a year to declare a dividend and pay the STC thereon. The dividend would be determined using the formula $100/110 \times \text{available profits}$.

Example 2 – Determining dividend that can be declared out of available profits

Facts:

XYZ (Pty) Ltd's balance sheet appeared as follows:

	R
Share capital	100
Revenue reserves (post-1993)	<u>100 000</u>
	<u>100 100</u>
Cash	<u>100 100</u>

Assuming that XYZ (Pty) Ltd is liquidated, determine the maximum dividend that should be declared to minimise the STC payable.

Result:

The maximum dividend that should be declared is $100/110 \times R100\ 000 = R90\ 909,09$. The STC on a dividend of R90 909,09 is $R90\ 909,09 \times 10\% = R9\ 090,91$. Thus the available profits of R100 000 would be dealt with as follows:

	R
Retained income	100 000,00
Less: Dividend declared	(90 909,09)
STC payable	<u>(9 090,91)</u>
Retained income after dividend and STC	<u>Nil</u>

In this final declaration situation the STC payable can also be determined by multiplying the available profits of R100 000 by $10/110 = R9\ 090,91$.

The fraction $100/110$ cannot be used in determining the amount of a deemed dividend under s 64C.

Example 3 – Determining amount of deemed dividend

Facts:

ABC (Pty) Ltd made a loan to its sole shareholder in year 1 when its balance sheet appeared as follows:

	R
Share capital	100
Revenue reserves (post-1993)	<u>100 000</u>
	<u>100 100</u>
Loan	<u>100 100</u>

In this situation there are profits of R100 000 available for distribution and since the amount advanced to the shareholder is R100 000 that is the amount of the dividend. The reduction of the company's reserves by the STC of R10 000 after the declaration of the deemed dividend does not affect the amount of the deemed dividend. At the time of its declaration there were profits of R100 000 available for distribution and the reduction of the company's reserves after the event is irrelevant. The same would apply if the company, albeit recklessly, declared an actual dividend of R100 000 in this example. An accumulated loss of R10 000 would result from the STC, but this does not reduce the amount of the dividend actually declared. The difference in the liquidation situation is that the actual dividend is deliberately set at a lower figure so that sufficient profits remain from which the STC can be paid.

3.8 Negative net amount

Should the sum of the allowable incoming dividends exceed the outgoing dividend, the excess is carried forward and deemed to be an incoming dividend in the next dividend cycle.

Small business tax amnesty

Under s 11(b) of the Small Business Tax Amnesty and Amendment of Taxation Laws Act 9 of 2006 an applicant may not carry forward a 'negative net amount' that arose during the amnesty period. Under s 8(e) of Act 9 of 2006 an applicant whose application has been approved is not liable for the payment of STC in respect of any dividend declared or deemed to be declared for the purposes of s 64B during the 'qualifying period', unless STC has already been paid in respect of certain dividends declared during that period. Under para (b) of the definition of that term in s 1, the qualifying period for STC purposes means

'any dividend cycle which ends in any year of assessment preceding the 2006 year of assessment'.

Example – Determination of net amount when dividends accrued exceed dividend declared*Facts:*

Company B last declared a dividend on 30 June 2007. On 31 August 2008 a going concern dividend of R10 000 accrued to Company B from Company C. On 30 June 2009 and 2010 respectively Company B declared dividends of R8 000 and R5 000. In all cases dividends declared by Company B accrued to its shareholders on the date of declaration.

Result:

Dividend cycle: 1 July 2007 to 30 June 2009

	R
Dividend declared	8 000
Less: Incoming dividend	<u>(10 000)</u>
Excess	<u>(2 000)</u>

Dividend cycle: 1 July 2009 to 30 June 2010

	R
Dividend declared	5 000
Less: Excess from previous dividend cycle	<u>(2 000)</u>
Net amount	<u>3 000</u>
STC 10% x R3 000	300

3.9 Incoming dividends**3.9.1 Allowable incoming dividends**

In determining the 'net amount', a company is entitled to deduct the sum of dividends (other than exempt s 64B(5)(c) dividends which qualify when the recipient company liquidates or deregisters – see 3.9.2) that have accrued to the company during the dividend cycle. Both dividends as defined in s 1 and amounts that are deemed to be dividends under s 64C(2) qualify as incoming dividends. It is clear from s 64B(3) that dividends as defined are intended to be both incoming and outgoing dividends for STC purposes. Under the definition of 'dividend' a dividend means

'any amount distributed by a company . . . to its shareholders . . .'.

Section 64C(2) employs similar wording, and for that reason should have the same effect as a defined dividend for STC purposes. It states that

'[for] the purposes of section 64B'

the amounts listed in the subsection are deemed to be a dividend

'declared by a company to a shareholder'.

If one of the purposes of s 64B(3) is to deal with incoming dividends, there is no reason to believe that the opening words in s 64C(2) 'for the purposes of section 64B' were not intended to include incoming dividends. It may also be inferred that the phrase 'to a shareholder' indicates an intention for deemed dividends to have consequences for shareholders.

Accrual of deemed dividends

One of the requirements of s 64B(3) is that the incoming dividend must have accrued to the company during the dividend cycle. The definition of 'declared' in s 64B(1) in relation to any dividend (including a dividend *in specie*), means

'the approval of the payment or distribution thereof by the directors of the company or by some other person under authority conferred by the memorandum and articles of association of the company or, in the case of the liquidation of a company, by the liquidator'.

From this definition it can be inferred that a deemed s 64C(2) incoming dividend would have accrued to a shareholder. Approval of payment means that the shareholder has entitlement and entitlement means accrual.

In the case of deemed dividends, s 64C does not, except for loan repayments under s 64C(5), supply a date of accrual. It only supplies dates of declaration in s 64C(6). The task of assigning accrual dates is left to s 64B(4), but that provision only supplies dates of accrual for transfers or distributions of cash or assets otherwise than by way of a formal declaration of a dividend, and by a liquidator during winding-up. This would not, it is submitted, cover a deemed dividend in the form of the discharge by a company of a shareholder's debt. In this regard SARS accepts that the dates of declaration in s 64C(6) should be used as accrual dates in cases in which such dates are not supplied by s 64B(4)(c).

Dividends distributed in anticipation or in the course of liquidation or deregistration

Incoming dividends that were exempted from STC under s 64B(5)(c) in the hands of the declaring company are only allowable as a deduction in determining the net amount when the recipient company itself is terminated – see **3.9.2** below.

Carry-forward of excess

When the incoming dividends exceed the dividend declared during a dividend cycle, the excess is treated as an allowable incoming dividend during the next dividend cycle – see **3.8**.

Dividends arising on a reduction of capital or on acquisition by a company of its shares

The definition of a 'dividend' in s 1 covers both outgoing and incoming dividends. Thus a company that buys back its own shares will generate an outgoing dividend to the extent that it acquires those shares out of its profits. The company that sold its shares will correspondingly have a deductible incoming dividend. The same principle applies to a dividend generated on a reduction of the share premium account to the extent that it comprises capitalised profits (see para (c) of the definition of a 'dividend').

An outgoing and corresponding deductible incoming dividend will also be triggered when a holding company generates a loss in its subsidiary by cancelling shares held by the subsidiary in that holding company (para (cB) of the definition of a 'dividend').

Allowable foreign dividends

Certain foreign dividends qualify as incoming dividends when the underlying profits consist of dividends that were subject to STC. This is discussed in **3.10.5**.

Non-qualifying dividends

As regards dividends that do not qualify as a deduction, see s 64B(3A) which is discussed in **3.10**.

Pre-acquisition dividends

A pre-acquisition dividend does not qualify as a deduction when distributed within a group of companies as defined in s 41 to the extent that the shareholder reduces the cost of the shares. This is because it is in fact not a dividend as defined, being excluded by para (g) of the definition of a 'dividend'. But a pre-acquisition dividend distributed by one company to another will qualify as a deduction when those companies do not form part of a s 41 group of companies.

Repayments of pure share capital or share premium

Care should be taken to ensure that amounts that do not qualify as dividends as defined in s 1 (for example, a repayment of 'pure' share premium) are not claimed as a deduction in determining the net amount.

Unclaimed dividends

The articles of a company listed on the JSE normally provide that when dividends remain unclaimed for a period of more than three years from the date on which they became payable, they may be forfeited and used for the benefit of the company. In these circumstances the company is not granted an allowable incoming dividend in respect of the forfeited dividend and the STC originally payable or paid remains unaffected.

3.9.2 Incoming s 64B(5)(c) dividends

Special rules, which are discussed below, exist for incoming dividends that were exempt from STC under s 64B(5)(c) in the hands of the declaring company.

Going concern dividend

A company that declares a going concern dividend (that is, it is not about to liquidate, wind up, deregister or finally terminate its existence) may not deduct an incoming dividend that was exempt from STC under s 64B(5)(c) in the hands of the declaring company. These incoming dividends are instead held in limbo until the recipient company itself terminates (see below).

Terminating dividend

A company that distributes a dividend in the course or in anticipation of

- its liquidation,
- winding-up,
- deregistration, or
- final termination of its corporate existence,

may deduct the sum of all previous incoming dividends that were exempt from STC under s 64B(5)(c) in the declaring company. In other words, all the exempt s 64B(5)(c) incoming dividends that were not allowed as a deduction in previous dividend cycles plus any such

dividend accruing during the current dividend cycle are added together and allowed as a deduction when the company itself declares a terminating dividend. It is not a requirement that the profits represented by the incoming dividend still be present in the recipient company at the time it eventually liquidates or deregisters, which could be many years later. It is simply the timing of the claiming of the STC credit that is deferred. The deferred dividend treatment only applies once, and is not repeated further up the line in a chain of companies. If the incoming dividend (which was exempt under s 64B(5)(c) in the declaring company) is on-distributed by the recipient, that outgoing distribution is not exempt from STC as it simply represents a distribution of profits that do not arise from the disposal of an asset (see *Defy Ltd v C: SARS*⁷⁶). However, the on-distributing company would be shielded from STC if it also terminates its existence at the time of the on-distribution (thereby accessing the deferred STC credit). The next recipient of the on-distributed dividend would not be subject to deferred credit treatment and will be granted an STC credit, thereby enabling the amount to flow in and out STC free through further companies higher in the chain without having to wait for the credit.

Example – Determination of net amount when incoming dividend is partially exempt under s 64B(5)(c)

Facts:

Company A last declared a dividend on 30 June 1998. On 31 December 2009 it declared a dividend of R110 000 to its shareholders. Between 1 July 1998 and 31 December 2009 it received the following dividends:

	R
Dividends on listed shares	5 000
Dividend from subsidiary	100 000

The subsidiary had been liquidated on 31 October 2007 and the dividend was declared during the course of winding-up out of the following profits:

	R
Pre-1993 revenue profits	20 000
Post-1993 revenue profits	30 000
Pre-1.10.2001 capital profits	10 000
Post-1.10.2001 capital profits	<u>40 000</u>
	<u>100 000</u>

The subsidiary had complied with s 64B(5)(c).

Result:

	R
Outgoing dividend	110 000
Less: Qualifying incoming dividends:	
Listed shares	(5 000)
Subsidiary	
– post-1993 revenue profits	(30 000)
– post-1 October 2001 capital profits	<u>(40 000)</u>
Net amount	<u>35 000</u>
STC 10% x R35 000	<u>3 500</u>

⁷⁶ 2010 (5) SA 416 (SCA), 72 SATC 99 .

Note: The portion of the dividend declared by the subsidiary out of pre-1993 profits and pre-1 October 2001 capital profits is not allowed as an incoming dividend because that portion was exempt in the subsidiary's hands under s 64B(5)(c). That portion will only qualify as an allowable incoming dividend when Company A itself is liquidated / wound up / deregistered / finally terminated.

3.10 Amounts excluded as incoming dividends (s 64B(3A))

Certain dividends are excluded as incoming dividends. Typically this occurs when the dividends concerned have not been subject to STC in the hands of the distributing company. The rationale is that such dividends should not be used to shield outgoing dividends in the recipient company, and should simply form part of the recipient's reserves to be subject to STC when eventually distributed.

The following are excluded as incoming dividends:

3.10.1 Fixed property company dividends exempt under s 64B(5)(b) (s 64B(3A)(a))

Under s 11(s) a 'fixed property company' is allowed a deduction for normal tax purposes in respect of any dividends distributed by it, other than dividends distributed out of profits of a capital nature. Such dividends flow through a collective investment scheme in property (CISP) which is a trust, and are taxed in the hands of the holder of the participatory interest (effectively representing 'net rental income'). Since such tax-deductible distributions are exempt from STC in the hands of the fixed property company under s 64B(5)(b), they do not qualify as incoming dividends in the hands of a holder of a participatory interest in the CISP. The *fiscus* will collect the STC when the participatory interest holder – if it is a resident company – declares the relevant profits as a dividend. A fixed property company that distributes a dividend out of profits of a capital nature will be subject to STC on the dividend so declared. Consequently, incoming dividends distributed out of profits of a capital nature by the fixed property company will qualify as allowable incoming dividends for STC purposes in the hands of corporate recipients (see s 64B(3)).

3.10.2 Intra-group dividends exempt under s 64B(5)(f) (s 64B(3A)(a))

Section 64B(5)(f) permits a subsidiary company to elect that certain outgoing dividends be exempt from STC. Again, such dividends do not qualify as incoming dividends in the hands of the recipient company. The exempt dividend simply forms part of the recipient's profits available for distribution and those profits will be subject to STC when distributed (unless the recipient is also able to make a s 64B(5)(f) election).

3.10.3 Dividends taxable under s 10(1)(k)(i)(bb) (s 64B(3A)(b))

This provision was deleted by s 51(1)(b) of the Taxation Laws Amendment Act 17 of 2009 with effect from 1 January 2010 and applicable to any dividend declared on or after that date. The commentary below therefore applies to dividends declared before that date. The deletion was consequential on the deletion of para (e)(i) of the definition of a 'company' in s 1, which had the effect that a CISS reverted to being a vesting trust.

Dividends declared before 1 January 2010

The general rule in s 10(1)(k)(i) is that local dividends are exempt from normal tax. However, s 10(1)(k)(i)(bb) excludes two types of local dividend from the general rule. These taxable dividends may not be deducted as incoming dividends in determining a recipient company's net amount. Under s 10(1)(k)(i)(bb) the exemption from normal tax does not apply

“to so much of any dividend as has been distributed by any portfolio of any collective investment scheme constituting a company in terms of paragraph (e)(i) of the definition of “company” in section 1—

- (A) out of income derived by such portfolio which is exempt from tax in the hands of such portfolio under the provisions of paragraph (iA); and
- (B) out of amounts received by or accrued to such portfolio by way of dividends referred to in section 11(s)’.

Paragraph (e)(i) of the definition of ‘company’ in s 1 included in the definition a portfolio of a South African-registered collective investment scheme in securities (CISS). Dividends distributed by such a ‘company’ (which in reality is probably a trust) are exempt from STC under s 64B(5)(j).

Section 10(1)(iA) exempts from tax

‘in the case of any portfolio of a collective investment scheme referred to in paragraph (e)(i) of the definition of “company” in section 1, so much of the income received by or accrued to such portfolio as has been distributed, or as the Commissioner is satisfied will be distributed, by way of a dividend or a portion of a dividend, to persons who have become entitled to such dividend by virtue of their being holders of participatory interest in such portfolio’.

Section 10(1)(k)(i)(bb)(A) refers to dividends from a CISS that are taxable in the hands of unit holders. Such amounts would usually comprise interest, taxable foreign dividends and security lending fees. Since such amounts would not have been subject to STC in the hands of the portfolio or foreign company it follows that they should not qualify as allowable incoming dividends.

Section 10(1)(k)(i)(bb)(B) refers to the situation in which a CISS holds a participatory interest in a CISP. Such dividends (representing net rental and interest income of the underlying property company), are taxable in the hands of the participatory interest holders. Since such amounts have not been subject to STC in the hands of the property company, CISP or CISS, it follows that they should not qualify as allowable incoming dividends.

3.10.4 Dividends accruing to a borrower under a securities lending arrangement (s 64B(3A)(c))

A borrower of shares under a ‘securities lending arrangement’ is not entitled to a deduction in respect of a dividend that accrued to that borrower in respect of the borrowed share during the borrowing period. In order to prevent tax avoidance, it is the intention that only beneficial owners of shares be entitled to a deduction in respect of dividends accruing in respect of those shares.

The term ‘securities lending arrangement’ is defined in s 1 as follows:

“[S]ecurities lending arrangement” means a “lending arrangement” as defined in the Securities Transfer Tax Act, 2007 (Act No. 25 of 2007).’

The Securities Transfer Tax Act 25 of 2007 defines a ‘lending arrangement’ as follows:

“[L]ending arrangement” means any arrangement in terms of which—

- (a) a person (hereinafter referred to as the lender) lends a listed security to another person (hereinafter referred to as the borrower) in order to enable that borrower to effect delivery (other than to any lender in relation to that borrower, unless the borrower can demonstrate that the arrangement was not entered into for the purposes of the avoidance of tax and was not entered into for the purposes of keeping any position open for more than 12 months) of that security within 10 business days after the date of

- transfer of that security from the lender to the borrower in terms of that arrangement;
- (b) that borrower in return contractually agrees in writing to deliver a listed security of the same kind and quality to that lender within a period of 12 months from the date of transfer of that security from the lender to the borrower in terms of that arrangement;
 - (c) that borrower is contractually required to compensate that lender for any distributions in respect of the listed security which that lender would have been entitled to receive during that period had that arrangement not been entered into; and
 - (d) that arrangement does not affect the lender's benefits or risks arising from fluctuations in the market value of the listed security,
- but does not include an arrangement where the borrower has not—
- (i) on-delivered the listed security within the period referred to in paragraph (a); or
 - (ii) returned the listed security contemplated in paragraph (b) to the lender within the period referred to in that paragraph.'

In a transaction falling outside the above definition, the borrower would be the beneficial owner of the borrowed securities. As such, the borrower would be entitled to an STC credit in respect of any dividends that accrued during the period from the date of acquisition until the securities are on-lent or sold.

Manufactured dividends

Securities-lending arrangements 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 STC. Any payment made by the borrower to the lender as a manufactured dividend is not a dividend for Income tax or STC purposes and must not be treated as a dividend by either the lender or the borrower. The manufactured dividend comprises gross income of the lender and will not qualify for the exemption under s 10(1)(k). A borrower paying a manufactured dividend will only be allowed a deduction in the determination of taxable income of the amount paid, if the amount meets the requirements of s 11(a)

A borrower is not liable to STC on the payment of a manufactured dividend, nor will the lender qualify for an STC credit on the amount received.

3.10.5 Certain foreign dividends (s 64B(3A)(d))

The general rule is that incoming foreign dividends are not allowed as a deduction in determining the net amount, though this was not always the case.⁷⁷ The rationale for this is that the declaring company would not have paid STC on the outgoing dividend. However, certain foreign dividends do qualify as allowable incoming dividends. This usually occurs when the underlying profits from which the dividend has been derived have been subject to

⁷⁷ In terms of the Taxation Laws Amendment Act 9 of 2005 it was provided that s 64B(3A)(d) does not apply in respect of any foreign dividend which accrued to the company during any year of assessment of that company commencing before 1 June 2004 and which is exempt from tax in terms of s 9E(7)(d) of the Income Tax Act. Section 9E, which exempted certain foreign dividends, was repealed by the Revenue Laws Amendment Act 45 of 2003 with effect from 1 June, 2004 and applicable in respect of any foreign dividend received or accrued during any year of assessment commencing on or after that date.

STC or the non-resident company paid a higher rate of South African normal tax has been paid on those profits to compensate for the fact that STC was not imposed.

The allowable dividends are as follows:

Electing gold mining companies and foreign companies with South African branches

An incoming foreign dividend will be allowable as a deduction *to the extent that*

- the profits from which the dividend has been distributed have been subject to tax at the applicable corporate rate in South Africa,
- that rate of tax has not been reduced under a double taxation agreement, and
 - the company mines for gold and elected to be exempt from the payment of STC (s 64B(3A)(d)(i)(aa)), or
 - the company carries on trade through a South African branch or agency (s 64B(3A)(d)(i)(bb)).

A company that carries on gold mining in South Africa that has elected not to pay STC will pay a higher rate of tax under a formula. Non-resident companies pay a tax on their taxable income derived from South Africa. The tax is imposed at a higher rate (33%) than the normal corporate rate of 28%.

The rationale for permitting such dividends as a deduction is that the underlying profits have been subject to South African tax at a rate that compensates for the non-payment of STC. An apportionment will have to be done in the case of a dividend partially derived from such South African-taxed profits and partly from other foreign profits to determine the allowable portion of the dividend. This follows from the use of the words 'to the extent'.

3.10.6 Amalgamation and unbundling transaction dividends (ss 44(9)(b) and 46(5)(b))

The corporate restructuring rules relating to amalgamation transactions (s 44) and unbundling transactions (s 46) provide an STC exemption for qualifying distributions. The *quid pro quo* for this concession is that corporate recipients of such exempt dividends are not permitted to claim them as incoming dividends.⁷⁸ This is discussed in 5.4 and 5.5.

3.11 Foreign dividends derived from dividends that have been subject to STC (s 64B(3A)(d)(ii))

An incoming foreign dividend will be allowable as a deduction when

- it arose directly or indirectly from a dividend declared by a resident company, and
- the resident company was subject to STC on the dividend it distributed.

The use of the words 'directly or indirectly' make it clear that a dividend that was subject to STC will be allowable as an incoming dividend even if it is derived by the foreign company from another foreign company. In other words, the dividend could travel through several layers of an offshore group structure before being declared to a South African resident company, yet will retain its status as an allowable incoming dividend.

The proviso – years of assessment commencing before 1 January 2010

⁷⁸ The incoming dividend is disallowed as a deduction in terms of s 44(9)(b) (amalgamation transactions) and s 46(5)(b) (unbundling transactions).

Before it was deleted by the Taxation Laws Amendment Act 17 of 2009, the proviso to s 64B(3A)(d)(ii) contained an important 'deemed tracing rule'.

In order for the deemed tracing rule to apply, the South African resident company receiving the foreign dividends must satisfy two requirements.

- First, the resident company must indirectly hold at least 10% of the equity share capital of the lower-tier South African company. This indirect interest can be held through one or more intermediary foreign companies.
- Secondly, no other resident company may hold an equal or greater interest in the lower-tier South African company. For purposes of this latter test, indirect interests held through the resident company are ignored.

If these deemed tracing rules apply, the foreign dividends received by the resident company generate STC credits to the extent that the lower-tier South African company distributes dividends to a foreign intermediate company (and those dividends have not already been taken into account under these provisions). These deemed tracing rules last as long as the resident recipient company holds at least an indirect 10% equity interest in the South African lower-tier declaring company.

Example – Deemed tracing rule (years of assessment commencing before 1 January 2010)

Facts:

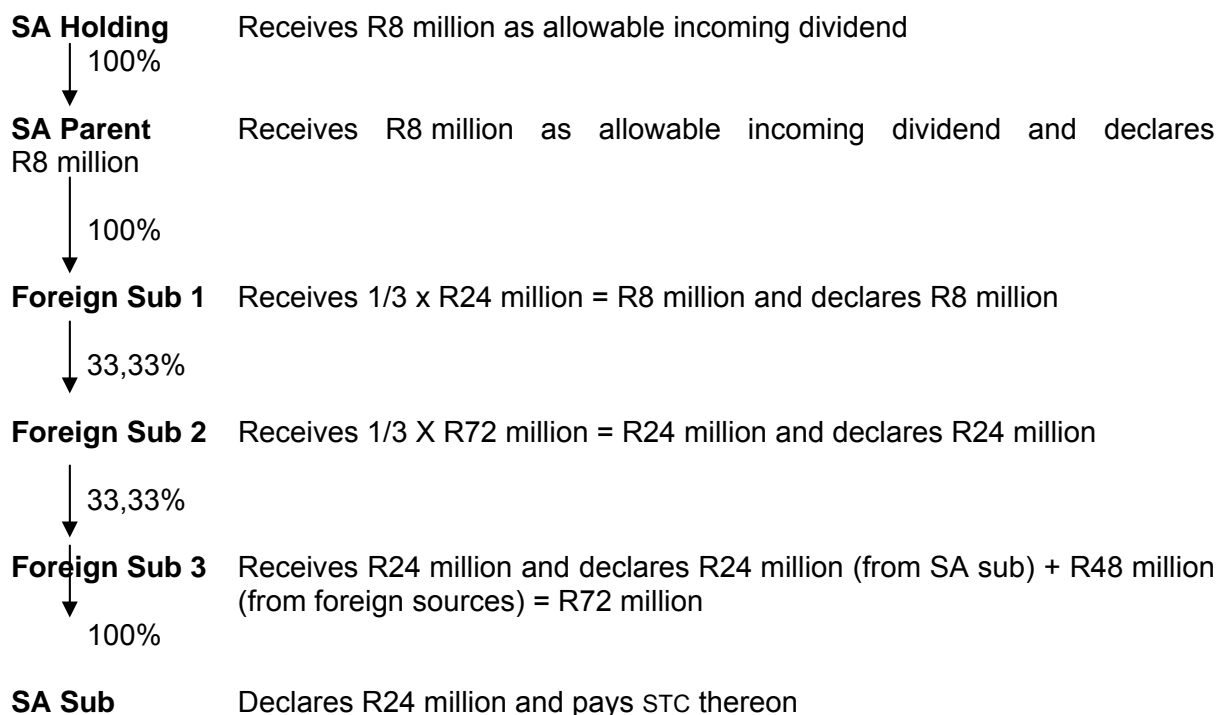
South African Holding Company owns all the shares of South African Parent Company.

South African Parent Company owns all the shares of Foreign Sub 1, a controlled foreign company under s 9D. Foreign Sub 1 owns 33,33% of Foreign Sub 2, and Foreign Sub 2 owns 33,33% of Foreign Sub 3. The remaining shares of Foreign Sub 2 and Foreign Sub 3 are publicly held by various wholly foreign parties, none of whom own more than 5% in any of these foreign companies. Foreign Sub 3 owns all the shares of South African Sub.

South African Sub distributes R24 million as dividends to Foreign Sub 3. Foreign Sub 3 generates R48 million profits in addition to the R24 million dividends. Foreign Sub 3 distributes all R72 million profits as dividends to its shareholders with Foreign Sub 2 receiving R24 million as its sole source of profits. Foreign Sub 2 distributes all R24 million in profits as dividends with Foreign Sub 1 receiving R8 million as its sole source of profits. Foreign Sub 1 distributes all R8 million of profits as dividends to South African Parent as its sole source of profits. South African Parent Company then distributes all R8 million in profits as dividends to South African Holding Company.

Result:

The result may be summarised as follows:



The tax impact of the dividend chain is as follows assuming no foreign taxes are imposed:

- (i) South African Sub is subject to STC on the full R24 million of profits distributed as dividends. The dividends are not subject to any South African tax in the hands of Foreign Sub 3 (s 10(1)(k)(i)).
- (ii) The R24 million of dividends distributed by Foreign Sub 3 to Foreign Sub 2 are wholly free from South African tax because the companies involved are wholly outside South Africa's taxing jurisdiction (neither being controlled foreign companies).
- (iii) The R8 million of dividends distributed by Foreign Sub 2 to Foreign Sub 1 are exempt from tax because Foreign Sub 1 owns at least 20% of the total equity share capital and voting rights in Foreign Sub 2 (ss 9D(2A) and 10(1)(k)(ii)(dd)).
- (iv) The R8 million of dividends distributed by Foreign Sub 1 to South African Parent are exempt from tax because South African Parent owns more than 25% of the participation rights in Foreign Sub 1 (s 10(1)(k)(ii)(dd)).
- (v) South African Parent receives STC credits for the full R8 million of foreign dividends received. First, the dividends indirectly arose from South African Sub. Secondly, South African Parent indirectly owns at least 10% (that is, $100\% \times 33,33\% \times 33,33\% \times 100\% = 11,11\%$) of South African Sub through its various foreign subsidiaries. Thirdly, no other single resident has an equal or greater interest in the equity share capital of South African Sub (except for the South African Holding company which owns an indirect interest through the South African Parent company). Hence, the R8 million dividends declared by Foreign Sub 1 are deemed to come out of profits from the R24 million of dividends declared by South African Sub, thereby generating R8 million of STC credits.

The proviso – years of assessment commencing on or after 1 January 2010

The proviso to s 64B(3A)(d)(ii) was deleted by s 51(1)(d) of the Taxation Laws Amendment Act 17 of 2009. The deletion comes into operation as from the commencement of years of assessment commencing on or after 1 January 2010. As a result, the deemed tracing rule no

longer applies. Any dividends declared by a resident company which have been subject to STC that are routed through a loop structure back to a resident company will have to be specifically traced in order for them to retain their character as SA-source dividends.

Example – Tracing of SA-source incoming dividends

Facts:

South African Company 1 holds 30% of Foreign Company, which in turn owns all the shares of South African Company 2. South African Company 2 distributes a dividend of R100 000 to Foreign Company. In addition to the dividend from South African Company 2, Foreign Company derived after-tax profits of R200 000 from foreign sources. Foreign Company declares a pro-rata dividend of R300 000 to all its shareholders out of current profits.

Result:

South African Company 1 receives a dividend of $30\% \times R300\,000 = R90\,000$. Since Foreign Company has distributed this dividend proportionately out of its profits from all sources, only $R100\,000/R300\,000 \times R90\,000 = R30\,000$ is regarded as being sourced from South African Company 2 dividends. Thus South African Company 2 will only be entitled to an STC credit of R30 000. Had Foreign Company maintained a separate reserve fund for its reserves derived from South African Company 2 dividends, and specified in a resolution that it was paying the R90 000 dividend to South African Company 1 out of the reserve fund, South African Company 1 would have been entitled to an STC credit of R90 000.

3.12 Deemed dates of accrual (s 64B(4))

The date when a dividend is deemed to accrue to a shareholder is important for two reasons. First, it establishes the end of the dividend cycle. Secondly, it determines when incoming dividends can be claimed as a credit when working out the 'net amount'. The end of the dividend cycle is not determined by the date of declaration of the dividend, but rather by the date of accrual of the dividend in the recipient's hands. Because the dividend cycle ends on the date of accrual of the outgoing dividend, it is possible that further incoming dividends can be received between the date on which an outgoing dividend is declared and the date on which the cycle ends. For example, a company may declare a dividend on 28 May that will be paid to shareholders on the share register on 10 June. Any incoming dividends that accrue to the company between 28 May and 10 June will reduce the 'net amount' which will be determined on 10 June. As regards a change in rate of STC between the date of declaration of a dividend and the date when it accrues to shareholders, see 3.6.

Section 64B(4) contains a number of deemed accrual timing rules which are set out in the table below.

Table 1 – Dates of accrual of incoming dividends

Section 64B(4)	Type of dividend declaration	Date of accrual to shareholders
(a)	Dividend or interim dividend payable to shareholders registered in the company's share register on a specified date. In practice this is the so-called 'record date'. When a share is sold cum div (with the dividend) the dividend will accrue to the buyer who will be entitled to the incoming dividend as an STC credit. In the case of a sale ex div (without the dividend) the incoming dividend	Specified date

	will accrue to the seller who will be entitled to the STC credit.	
(b)	Interim dividend not covered by para (a)	Date of declaration
(c)(i)	Cash or assets transferred or distributed to shareholders otherwise than by way of a formal declaration of a dividend (e.g. as a result of a share buy-back or reduction in share capital).	Date on which shareholders become entitled to cash or assets.
(c)(ii)	Cash or assets transferred or distributed to shareholders by the liquidator of the company in the course of the winding-up or liquidation of the company.	

3.13 Exemptions from STC (s 64B(5))

Certain dividends declared by a company are exempt from STC. These are discussed below.

3.13.1 Completely exempt companies (s 64B(5)(a))

Dividends declared by the following types of company are exempt from STC:

- Companies whose entire receipts and accruals are exempt from tax under s 10.
- Companies whose receipts and accruals excluding investment income are exempt from tax under s 10.

Neither exemption applies to companies that are exempt solely because they derive gross income of a particular nature. For example, a company that only receives dividend income that is exempt from tax under s 10(1)(k) will not automatically be exempt from STC. It must prove that it would be exempt from tax if it received any type of income.

A company that is a registered micro business under the Sixth Schedule is excluded from s 64B(5)(a). A micro business enjoys a limited STC exemption under s 64B(5)(l).

Examples of the first category of company include the following:

- A company that enjoys complete exemption under s 10(1)(cA)(ii) because all its shares are held by an institution that is itself exempt under s 10(1)(cA)(i).
- An association of persons that enjoys complete exemption under s 10(1)(d) (for example, a professional body enjoying exemption under s 10(1)(d)(iv)(bb)).
- A subsidiary of Armscor that enjoys complete exemption under s 10(1)(f)(vi).

Example – Company completely exempt from tax under s 10 that is also exempt from STC

Facts:

The ABC University which enjoys complete exemption from tax under s 10(1)(cA)(i) formed a company for the purpose of performing medical research. All the shares in the company are held by the ABC University.

Result:

Since the ABC University is exempt from tax under s 10(1)(cA)(i) the company it formed will be completely exempt from tax under s 10(1)(cA)(ii). The company will accordingly be exempt from STC under s 64B(5)(a).

The reference to a second category of company, namely, one enjoying exemption on its receipts and accruals other than investment income, would seem to be obsolete. It probably referred to certain companies that used to enjoy partial exemption from tax under s 10(1)(e). However, s 10(1)(e) in its present form only exempts levy income. It follows that under the proviso to s 64B(5)(a) companies whose levy income is exempt (for example, a share block company) will not enjoy exemption from STC because they are capable of deriving taxable income other than from investments.

3.13.2 Dividends declared by a fixed property company under s 11(s) (s 64B(5)(b))

A dividend declared by a fixed property company contemplated in s 11(s) which is allowable as a deduction in determining its taxable income is exempt from STC.

A fixed property company is one owned by a portfolio of a collective investment scheme in property (CISP). Such a company is permitted to claim a deduction under s 11(s) in respect of any dividends it declares to the CISP, other than those distributed out of profits of a capital nature. The *quid pro quo* for the STC exemption granted to the fixed property company is that the dividend is not allowed as a deductible incoming dividend in the hands of a company that holds a participatory interest in the CISP (see s 64B(3A)(a)). Thus the underlying profits flowing from the fixed property company (comprising net rental and interest income) will be subject to STC when the recipient company declares them to its shareholders.

Since dividends declared by a fixed property company out of profits of a capital nature do not qualify for deduction under s 11(s), it follows that the exemption in s 64B(5)(b) does not apply to such dividends, and they will be subject to STC.

3.13.3 Terminating dividends (s 64B(5)(c))

3.13.3.1 Scope

Section 64B(5)(c) exempts from STC dividends declared out of certain profits by a company in the course or in anticipation of its

- liquidation,
- winding-up,
- deregistration, or
- final termination of its corporate existence.

3.13.3.2 Meaning of ‘in the course of’

The term ‘in the course of’ typically applies to the liquidation or winding up of a company rather than to the process of deregistration. Liquidation commences on the ‘date of liquidation’ (see 2.4.4) and continues until the date of dissolution.

3.13.3.3 Meaning of ‘in anticipation of’

The term ‘in anticipation of’ covers distributions before the date of liquidation, deregistration or final termination of a company, but the legislation is silent on what is required before a dividend can be described as being made in anticipation of these events. This will have to be judged from the intention of the company as expressed in its minutes of meetings and actions of its directors. Even if a company did distribute a dividend in anticipation of its liquidation, deregistration or final termination, it must still take the steps contemplated in s 41(4) within the period referred to in s 47(6)(c)(i) if it wishes to avail itself of the exemption (proviso to s 64B(5)(c)).

3.13.3.4 Qualifying profits

The profits out of which a dividend that is exempt under s 64B(5)(c) may be declared are as follows:

a) Pre-1993 profits (s 64B(5)(c)(i))

The exemption applies to a distribution out of profits derived during any year of assessment which ended not later than 31 March 1993. Excluded are any such profits derived by way of the revaluation of trading stock held by the distributing company.

The exclusion of profits derived from the revaluation of trading stock during any year of assessment which ended not later than 31 March 1993 was an anti-avoidance measure aimed at preventing companies from artificially boosting their pre-1993 profits by revaluing trading stock.

The Act is silent on the order in which profits are deemed to be distributed. This can be problematic when dividends have been declared during years of assessment ending on or after 31 March 1993. SARS accepts that in the absence of a resolution identifying the profits out of which a dividend has been declared, profits are distributed on a last-in-first-out (LIFO) basis. This works to the benefit of taxpayers as it ensures that any potentially STC-exempt pre-1993 profits are preserved until a company is liquidated or deregistered – provided of course that any dividends declared in the post-1993 period do not exceed the post-1993 profits available for distribution. This is consistent with the now repealed s 64B(17) which stipulated the LIFO basis for long-term insurers.

The true legal position remains uncertain, however. The issue was examined in the 1950 decision of *CIR v Auroch's Investment Co (SA) Ltd*⁷⁹ that was cited with approval in *CoT v Emanuel*.⁸⁰ In delivering the judgment in *Emanuel's* case, Lewis AJP said:⁸¹

‘As Clayden J pointed out in *CIR v Auroch's Investment Co (SA) Ltd* 1951 (1) SA 647 (T) at 652A:⁸²

“It is not I think a matter of law that dividends are always to be regarded as being paid out of profits proportionately as those profits have been earned in various years. If enquiry has to be made as to which profits provided a dividend it is perhaps as good a way as any to adopt a proportionate basis. But in this case to show double taxation it has to be proved that the profits already taxed were distributed as the dividend.”

‘This seems to involve the same principle as is applied in cases in which the taxpayer claims a deduction in respect of expenditure incurred by him in the earning of his income for any particular tax year, where the onus is also on him to identify and establish the amount in respect of which he claims a deduction. See, for example, the case of *Commissioner of Taxes v Cathcart* 1965 (1) SA 507 (SRAD)⁸³ 41 where this court, at 512 of the report, adopted what was said by Price J in *Income Tax Case 698* reported in 17 SATC 97.⁸⁴ In that the case the learned judge had said, at 98:

“Where some of the money is expended for a dual purpose and one of those purposes would not qualify the expenditure for deduction from income for tax purposes, it seems that no portion of the amount expended may be so deducted.”

‘The onus being on the taxpayer, it is for him to prove positively and precisely from what source of profit a dividend, which is prima facie liable to tax, has been appropriated if he

⁷⁹ 1951 (1) SA 647 (T), 17 SATC 443.

⁸⁰ 1971 (4) SA 266 (RAD), 33 SATC 149.

⁸¹ At SATC 155.

⁸² 17 SATC 443 at 448.

⁸³ *CoT v Cathcart* 1965 (1) SA 507 (SRAD), 27 SATC 1.

⁸⁴ ITC 698 (1950) 17 SATC 97 (T).

seeks to discharge the onus of establishing double taxation. Failure to do so renders the whole dividend liable to tax.'

Emanuel's case was followed by another Rhodesian case, *G v CoT*⁸⁵ in which the court had to determine out of which profits particular dividends had been declared. The court examined various British and Australian decisions. The principle extracted from the British decisions was that in the absence of evidence to the contrary, it could be inferred that a taxpayer who appreciated the implications would adopt the course of action most favourable to him. This principle could not be applied when the taxpayer was ignorant of the implications or when the appropriation was made by a third party who derived no advantage from it. The judge found that the Australian decisions were not harmonious. In two of the three Australian cases⁸⁶ the judges favoured the LIFO approach on the grounds that it was a common sense approach adopted by men of business. In the third case, *Commissioner of Taxation NSW v Freeman*⁸⁷ the court took a different view, namely, that the company had to show that there had been 'a deliberate appropriation made . . . with the authority of the company'. Greenfield J, who presided in *G's* case, felt obliged to follow the *ratio* in *Auroch's* case and as a consequence the taxpayer lost his appeal.

b) Pre-1 October 2001 capital profits (s 64B(5)(c)(ii))

Under s 64B(5)(c)(ii) a dividend will be exempt from STC if distributed out of profits of a capital nature other than

'capital profits attributable to the disposal of any asset on or after 1 October 2001 which capital profits must, in the case of an asset acquired before that date, be limited to the amount of profit determined as if that asset had been acquired on 1 October 2001 for a cost equal to the market value of that asset on that date determined in the manner contemplated in paragraph 29 of the Eighth Schedule'.

Thus there are two categories of capital profits that do not qualify for exemption under s 64B(5)(c).

Category 1 – Capital profits on assets acquired and disposed of on or after 1 October 2001

A capital profit arising on disposal of an asset acquired on or after 1 October 2001 will be fully subject to STC. Conversely a capital profit on an asset acquired and disposed of before 1 October 2001 will be exempt from STC.

Category 2 – Post-CGT portion of capital profits on assets acquired before and disposed of on or after 1 October 2001

For an asset acquired before 1 October 2001 but disposed of on or after that date it is necessary to split the capital profit between the periods before and on or after 1 October 2001. The post-1 October 2001 portion of the capital profit will be subject to STC, while the pre-1 October 2001 portion will qualify for exemption. For the purpose of splitting a capital profit into pre- and post-1 October 2001 portions, a taxpayer is treated as having acquired the asset on 1 October 2001 at a cost equal to

'the market value of that asset on that date *determined in the manner* contemplated in paragraph 29 of the Eighth Schedule'.

(Emphasis added.)

⁸⁵ 1971 (4) SA 274 (R), 33 SATC 213.

⁸⁶ *FCT v Foster Brewing Co Ltd* [1917] 22 CLR 545 (HCA) and *Commercial Banking Co of Sydney Ltd v FCT* [1917] 23 CLR 102.

⁸⁷ 6 AIR 225.

Section 64B(5)(c)(ii) was amended by s 58(1)(i) of the Revenue Laws Amendment Act 45 of 2003, which added the underlined words. The intention in adding these words was to make it clear that para 29(4) of the Eighth Schedule had to be complied with. This is confirmed by the Explanatory Memorandum to the applicable clause in the underlying Bill, which stated the following:

‘As part of the *quid pro quo* for the extension of the deadline for the preparation of valuations for CGT purposes, the proposal makes it clear that the deadline will also apply to valuations for the purposes of the exemption of the distribution of capital profits from STC.’

SARS regards the entire capital profit as being subject to STC when a taxpayer has failed to complete a valuation by 30 September 2004.⁸⁸

The time limit for performing valuations does not apply to assets the prices of which were published in the *Government Gazette*, such as listed South African shares.

Allocation of losses

Allocation of capital profit between pre- and post-1 October 2001 periods on individual assets

What happens when the market value determined under para 29 results in a capital loss in the pre-1 October 2001 period and a capital profit in the post-1 October 2001 period? In this situation the amount that is subject to STC is limited to the actual capital profit available for distribution. In other words, the post-1 October 2001 capital profit must be reduced by the pre-1 October 2001 capital loss.

Example 1 – Asset producing pre-1 October capital loss and post-1 October 2001 capital profit

Facts:

A company bought an asset for R100 in 1985. Its market value on 1 October 2001 was R50 and it was distributed *in specie* during winding-up when its market value was R110.

Result:

The company has a pre-1 October 2001 capital loss of R50 and a post-1 October 2001 capital profit of R60. In these circumstances the dividend must be limited to the amount available for distribution, namely, R10 (R110 – R100).

It may happen that an asset will produce a pre-CGT capital profit and a post-CGT capital loss. In this situation the amount of the STC-exempt pre-CGT capital profit is limited to the overall capital profit as illustrated in the example below.

Example 2 – Asset producing pre-1 October capital profit and post-1 October 2001 capital loss

Facts:

A liquidating company has disposed of an asset, details of which are as follows:

R

⁸⁸ See para 3.11 of the SARS / National Treasury response document on the Revenue Laws Amendment Bill, 2005 dated 1 November 2005, available from the SARS website at <<http://www.sars.gov.za/home.asp?pid=2635>> [Accessed 21 September 2010].

Cost	100
Market value on 1 October 2001	200
Proceeds	150
<i>Result:</i>	
Pre-1 October 2001 capital profit	100
Post-1 October 2001 capital loss	(50)
Overall capital profit	<u>50</u>

In this case there is no capital profit attributable to the period on or after 1 October 2001. The pre-1 October 2001 capital profit of R100 is limited to the overall capital profit of R50 and will be exempt from STC.

Post-1 October 2001 expenditure

Expenditure incurred on or after 1 October 2001 on an asset must be allocated against the post-1 October 2001 portion of a capital profit. This would apply, for example, to costs such as selling expenses, CGT and STC.

Example 3 – Post-1 October 2001 improvements

Facts:

A company acquired an asset at a cost of R100 in 1990. On 1 October 2001 the market value of the asset was determined at R150. In 2004 the asset was improved at a cost of R50. It was sold in 2009 for R600. Assume that the company has no other reserves available for distribution and uses the market value of the asset in determining the valuation date value of the asset for CGT purposes.

Result:

CGT on the asset amounts to $R600 - R150 - R50 = R400 \times 50\% \times 28\% = R56$

The post-1 October 2001 portion of the capital profit is determined as follows:

	R
Proceeds	600
Less: Market value of asset on 1 October 2001	(150)
Improvements	(50)
CGT	<u>(56)</u>
Capital profit derived after 1 October 2001	344
Capital profit derived before 1 October 2001 (exempt from STC under s 64B(5)(c)) (R150 – R100)	<u>50</u>
Overall capital profit	<u>394</u>

Dividend subject to STC = $R344 \times 100/110 = R313$

STC = $R313 \times 10\% = R31,30$

Allocation of losses against profits

Section 64B(5)(c) is silent as to how capital and revenue losses are to be allocated against capital and revenue profits.

Paragraph (v) of the first proviso to the definition of 'dividend' lays down basic rules for allocating losses at the commencement of the winding-up or liquidation of a company. It applies when

- a company has lost some of its share capital (that is, it has an accumulated loss) and
- has capitalised reserves.

Under para (v)(aa)

- capital losses are set off against capitalised capital profits, and
- revenue losses are set off against capitalised revenue profits.

However, para (v) does not cover dividends declared in anticipation of liquidation, deregistration or final termination or situations in which reserves have not been capitalised. Nevertheless, it is submitted that as a starting point it would be logical to extend the principles laid down in para (v) to these other circumstances.

Some guidance on the allocation issue may be provided by the cases dealing with apportionment. South African courts have on a number of occasions dealt with apportionment of lump sum payments. In *SIR v Guardian Assurance Holdings (SA) Ltd* Muller JA stated that there were⁸⁹

‘possible methods by which a logical and fair apportionment could be made’.

Corbett JA (as he then was) expressed similar sentiments in *CIR v Nemojim* in which he said the following:⁹⁰

‘In making such an apportionment the court considers what would be fair and reasonable in the circumstances of the case.’

It is submitted that the allocation of losses should similarly be done on a logical, fair and reasonable basis, taking into account the circumstances of each case.

Revenue losses arising in previous years would have reduced any capital profits existing at that time.

Example 4 – Absorption of capital profits by revenue losses during the lifetime of a company

Facts:

In year 1 a company derives a capital profit of R100 and a revenue profit of R100. In year 2 the company makes a revenue loss for the year of R200. In year 3 the company makes a revenue profit of R100.

Result:

	Year 1	Year 2	Year 3
	R	R	R
<i>Capital profit:</i>			
At beginning of year	-	100	-
Current year	100	-	-
Less: Absorbed	-	(100)	-
At end of year	100	-	-
<i>Revenue profit / (loss):</i>			
At beginning of year	-	100	-
Current year	100	(200)	100
Applied against capital profit	-	100	-
At end of year	100	-	100

⁸⁹ 1976 (4) SA 522 (A), 38 SATC 111 at 126.

⁹⁰ 1983 (4) SA 935 (A), 45 SATC 241 at 260.

The capital profit of R100 is absorbed by the revenue loss of R100 and there is therefore nothing to carry forward.

In practice the issue of the absorption of capital profits by revenue losses tends to arise upon liquidation, winding-up, deregistration or final termination of a company's corporate existence. Capital profits will tend to arise in the year of termination and the question then arises as to how the capital profits should be absorbed by the revenue losses.

The artificial split of capital profits between the pre- and post-1 October 2001 periods has introduced an additional complication. This applies when pre-valuation date assets are disposed of on or after 1 October 2001. In reality a capital profit is only realised on disposal of an asset, but para (a) and s 64B(5)(c) allocate capital profits on an accrual basis between two time periods. In order to be consistent, it is logical and fair that in determining the net capital profits available for distribution in a certain period, capital and revenue losses must also be allocated on a time basis.

SARS does not accept that capital and revenue losses can automatically be set off against post-valuation date capital profits in preference to pre-valuation date profits. That approach would be neither logical nor fair and reasonable.

The following guidelines are recommended:

- Capital losses must be set off against capital profits, and revenue losses against revenue profits. This is consistent with the approach in para (v) of the first proviso.
- The portion of revenue losses incurred before 1 October 2001 must in the first instance be set off against pre-1 October 2001 capital profits.
- The portion of revenue losses incurred on or after 1 October 2001 must in the first instance be set off against post-1 October 2001 capital profits.
- If a pre-1 October 2001 revenue loss exceeds a pre-1 October 2001 capital profit, the excess should be set off against any post-1 October 2001 capital profits.
- If a post-1 October 2001 revenue loss exceeds a post-1 October 2001 capital profit, the excess should be set off against any pre-1 October 2001 capital profits.
- The Act does not make provision for the allocation of capital losses between the pre- and post-valuation date periods in respect of the disposal of pre-valuation date assets. Such losses must be regarded as arising in the post-valuation date period when realised. Revenue losses arise as and when incurred (realised).

The table below illustrates the allocation of capital and revenue losses.

Table 1 – Examples of allocation of losses

Example	Pre-1 October 2001	Post 1 October 2001
Example 1		
Capital profit	100	100
Capital loss – realised pre-1 October 2001	(120)	-
Allocate loss	(100)	(20)
Dividend	-	80
Example 2		
Capital profit	100	100
Capital loss – realised on or after 1 October 2001	-	(120)

Allocate loss	(20)	(100)
Dividend	80 (exempt)	-
Example 3		
Capital profit	100	100
Revenue loss – realised pre-1 October 2001	(120)	-
Allocate loss	(100)	(20)
Dividend	-	80
Example 4		
Capital profit	100	100
Revenue losses – realised before and on or after 1 October 2001 respectively	(50)	(50)
Dividend	50 (exempt)	50
Example 5		
Capital profit	100	100
Revenue loss – realised on or after 1 October 2001	-	(120)
Allocate loss	(20)	(100)
Dividend	80 (exempt)	-

Depreciable assets

Under GAAP depreciation is recognised in the income statement as an expense that arises in the course of the ordinary activities of the enterprise (Framework for the Preparation and Presentation of Financial Statements). According to IAS 16 'Property, Plant and Equipment' the gain or loss from the 'derecognition' (for example, sale) of an item of property, plant or equipment is included in profit or loss. Gains must not be classified as revenue (for example, in the same way as a sale of goods). The recognition of revenue is dealt with in IAS 18. These and other GAAP statements do not, however, address what constitutes a profit of a capital or revenue nature.

In *Edwards v Saunton Hotel Co Ltd* Atkinson J said the following:⁹¹

'It has been decided that, if a company writes off excessive depreciation, it is in truth only creating a reserve which can be brought into revenue again at any time it likes and become available for profits. One of the cases which decided that is *Stapley v Read*.⁹²

The legal (as opposed to accounting) concept of a realised capital profit or loss is simply the difference between the proceeds and the cost of the asset. Depreciation is neither an expense actually incurred nor a capital loss, but simply an appropriation of profits to a reserve fund (being the provision for depreciation). When the asset is sold, the accounting profit is determined as follows:

Proceeds on disposal (capital)	R
	xx
Less: Cost of asset (capital)	(xx)
Capital profit (loss)	xx
Release of previously appropriated revenue profits	<u>xx</u>
Profit or loss	<u>xx</u>

When a depreciable asset is sold above its carrying value but below cost, the 'profit' represents the amount by which the previously appropriated revenue profits exceed the

⁹¹ [1943] 1 All ER 176.

⁹² *Stapley v Read Bros Ltd* [1924] 2 Ch 1, Digest Supp, 93 LJCh 513, 131 LT 629.

capital loss, and hence the net accounting profit is of a revenue nature. But when a depreciable asset is sold above cost, the excess represents a capital profit.

Example 5 – Depreciable asset

Facts:

A company purchased an asset for R100 and commenced depreciating it on the straight-line basis over five years for accounting purposes. After three years, the company sold the asset for proceeds of R120.

Result:

The resulting profit of R80 is arrived at as follows:

	R
Cost	100
Less: Accumulated depreciation R20 x 3	<u>(60)</u>
Carrying value	40
Proceeds	<u>(120)</u>
Profit on disposal	<u>80</u>

The capital and revenue components of this profit are determined as follows:

	R
Proceeds (capital)	120
Less: Cost (capital)	<u>(100)</u>
Capital profit	20
Reversal of provision (ex revenue profits)	<u>60</u>
Total profit	<u>80</u>

Thus, the amount by which the proceeds (R120) exceed the cost (R100), namely, R20, is a capital profit, while the amount of R60 represents revenue profits appropriated in previous years.

Under IFRS 3 'Business Combinations', goodwill must be carried at cost less any accumulated impairment losses. It is no longer permissible to amortise goodwill over its expected useful life. Instead, the carrying value of goodwill must be tested for impairment on an annual basis under (IAS 36) 'Impairment of Assets'. Such impairment losses are regarded as being of a capital nature. Under IFRS 3 negative goodwill is recognised immediately as a gain in the income statement.⁹³

Unrealised capital profits

Unrealised capital profits are determined by comparing an estimated value of the assets with their book value.⁹⁴ Under the third proviso to the definition of a 'dividend' unrealised profits must be taken into account regardless of whether they have been recognised in the company's financial records. Under s 64B(1) the term 'profit' includes

'any amount deemed in terms of the definition of "dividend" in section 1 to be a profit available for distribution'.

It follows that an unrealised profit associated with a distribution in specie must be taken into account for STC purposes.

⁹³ IFRS 3 (AC 140) 'Business Combinations' in paras 56–57.

⁹⁴ *Dimbula Valley (Ceylon) Tea Co Ltd v Laurie* 1961 Ch 353, [1961] 1 All ER 769.

Example 6 – Distribution of unrealised profit in course of liquidation*Facts:*

C owns all the shares in Propco (Pty) Ltd. The company's sole asset comprises a residential property acquired in 1990 at a cost of R100 000. The purchase of the property was funded by share capital of R100 and a shareholder's loan of R99 900.

On 28 February 2010 C decided to liquidate the company and transfer the property into his own name. The company had obtained a valuation for CGT purposes of the property before 30 September 2004, which reflected the value as R500 000 on 1 October 2001. The company was placed in liquidation on 30 June 2010 and on 31 August 2010 the property was transferred to C at which time its market value was R700 000. Propco incurred the following expenses:

	R
CGT $R200\ 000 \times 50\% \times 28\%$	28 000
Liquidation expenses	7 000
STC $(R200\ 000 - R28\ 000 - R7\ 000) \times 10/110$	15 000

Summary:

The total dividend of R550 000 is made up as follows:

	Pre-1 October 2001 R	Post-1 October 2001 R	Total R
Unrealised capital profit	400 000	200 000	600 000
Less: CGT	-	(28 000)	(28 000)
Liquidation costs	-	(7 000)	(7 000)
STC	-	(15 000)	(15 000)
Capital profit available for distribution	<u>400 000</u>	<u>150 000</u>	<u>550 000</u>

Check: STC = R150 000 x 10% = R15 000

The meaning of 'profit of a capital nature'

A capital profit is not the same as a 'capital gain', which is precisely defined in the Eighth Schedule. For example, the base cost of a listed share includes one-third of the interest paid in financing the acquisition of the share. But for accounting purposes such interest would be treated as an expense deductible against dividend income.

There is no definition in the Act of what constitutes profits of a capital nature, In *Defy Ltd v C: SARS*⁹⁵ it was held that in the context of s 64B(5)(c) the term referred to the pecuniary gain earned upon disposal of a capital asset. Since an amount derived from the waiver of a liability is not derived from the disposal of a capital asset it does not qualify for exemption under s 64B(5)(c).

The nature of profits derived during winding-up

One of the first South African cases dealing with the taxation of profits earned by a company in liquidation was ITC 172.⁹⁶ That case involved a real estate company that was placed in voluntary liquidation. At the date of liquidation it owned certain land that had been cut up into plots for realisation. The liquidator disposed of this land during the winding-up period on the

⁹⁵ 2010 (5) SA 416 (SCA), 72 SATC 99.

⁹⁶ (1930) 5 SATC 171 (U).

same terms as that adopted by the company before the date of liquidation. During the winding-up period rents were also received from other properties. The Commissioner having subjected the profit on disposal of land and rental income to taxation, the taxpayer objected on the grounds that the amounts were an accretion of capital through the realisation of the assets of the company by the liquidator. The court dismissed the appeal, holding that the gradual disposal of the assets of the company over a number of years on the same terms and conditions as the company dealt with and disposed of them before liquidation amounted to the carrying on of its business. As a consequence, the proceeds of the sales constituted gross income and not receipts of a capital nature. The Acting President of the Special Court, A. Davis KC found support for his conclusion in the British case of *J & R O'Kane & Co v CIR*.⁹⁷ After quoting a passage from this case the learned President went on to say the following:⁹⁸

'in this case, from the point of view of the world the company was engaged in trading in the ordinary way, but it had modified its method of internal management, namely, by deciding to go into voluntary liquidation. From the point of view of the world its trade was being carried on and from the point of view of the company no alteration had been made in the system of selling its property.'

The courts will primarily examine the nature of a company's activities before date of liquidation in deciding whether the transactions taking place during winding-up are of an income or capital nature.

Can a dividend form part of a profit of a capital nature?

The SCA case of *Defy Ltd v C: SARS*⁹⁹ raised the question whether a dividend received in anticipation of liquidation was of a capital nature. This becomes an issue when a holding company has acquired its investment in its subsidiary before 1 October 2001 and then proceeds to liquidate the subsidiary. The appellant holding company in the *Defy* case treated the dividend as part of the proceeds on disposal of its subsidiary's shares. In this way the appellant holding company generated what it claimed was a pre-1 October 2001 capital profit on disposal of its subsidiary's shares which it claimed was exempt from STC under s 64B(5)(c) when on-distributed. At the same time the appellant holding company claimed a credit for the incoming dividend when it liquidated. This resulted in an unwarranted double benefit. Before discussing the facts of the *Defy* case in detail, it is helpful to illustrate the issues that arose in that case by means of a simple example.

Example 7 – On-distributions

Facts:

H owns all the shares in S which it acquired upon formation of S at a cost of R1. Immediately before its liquidation S's balance sheet appeared as follows:

	R
Share capital	1
Capital profit (pre-CGT)	<u>100</u>
Cash	<u>101</u>
	<u>101</u>

Immediately before the liquidation of S and H, H's balance sheet appeared as follows:

	R
Share capital	1

⁹⁷ 12 TC 303.

⁹⁸ At SATC 173.

⁹⁹ 2010 (5) SA 416 (SCA), 72 SATC 99.

Revenue profits (post-1993)	<u>100</u> <u>101</u>
Shares in S	1
Cash	<u>100</u> <u>101</u>

S distributed the pre-CGT capital profit in anticipation of its liquidation. H valued the shares in S at R101 as at 1 October 2001. Both H and S comply with s 41(4).

Determine the STC consequences of the liquidation of H and S.

Result (according to proponents of the *Defy* scheme):

S's position

S has no STC liability on the dividend of R100 as the amount is exempt under s 64B(5)(c). SARS agrees with this treatment.

H's position

H treats the dividend and return of share capital of S as proceeds on disposal of S for accounting purposes. This, so it is contended, generates a pre-CGT capital profit of R101 – R1 = R100 in H's hands. When H liquidates it claims exemption from STC under s 64B(5)(c) in respect of the outgoing dividend declared out of this amount. H also claims an STC credit for the incoming dividend from S of R100 under s 64B(3). Thus H has no liability for STC on its own post-1993 retained income.

	R
Dividend declared	200
Less: Exempt pre-CGT capital profit (s 64B(5)(c))	(100)
Less: Incoming dividend (s 64B(3))	<u>(100)</u>
Net amount	<u>Nil</u>

The above contention was rejected by the SCA in the *Defy* case discussed below. The incoming dividend does not comprise a 'profit' as it does not involve the disposal of an asset. When the dividend was received from the subsidiary, the subsidiary's shares were still held by the holding company. The holding company is therefore not entitled to treat the dividend as part of the proceeds on disposal of its shares in its subsidiary. The incoming dividend therefore simply forms part of the holding company's reserves available for distribution. Although the outgoing dividend distributed from these reserves is not exempt from STC it is shielded by the incoming dividend.

The STC computation should be as follows:

	R
Dividend declared	191
Less: Incoming dividend (s 64B(3))	<u>(100)</u>
Net amount	<u>91</u>
STC payable R91 x 10%	9,10

The Defy case

The facts in the *Defy* case referred to above were that a holding company (*Defy* – the appellant) received a distribution from its subsidiary, *Defy Appliances (Pty) Ltd* (*Appliances*) of R343 811 457 in anticipation of *Appliance's* liquidation. The distribution was made up as follows:

	R
Pre-CGT capital profit exempt from STC under s 64B(5)(c)	206 080 509
Profits exempt from STC under s 64B(5)(f)	<u>68 919 491</u>
Dividend as defined in s 1	275 000 000
Return of share premium account (not a 'dividend' as defined in s 1)	<u>68 811 457</u>
Total distribution	<u>343 811 457</u>

Defy used this incoming distribution to determine a 'capital profit' on 'disposal' of its shares in Appliances as follows:

	R
Total distribution from Appliances	343 811 457
Less: Original cost of Defy's investment in Appliances	<u>(28 451 459)</u>
Total 'capital profit' realised by Defy	<u>315 359 998</u>
Comprising:	
Pre-CGT portion [claimed to be exempt under s 64B(5)(c)]	305 311 541
Post-CGT portion	<u>10 048 457</u>
	<u>315 359 998</u>

Defy in turn made a distribution in anticipation of its own liquidation and presented the following determination of its net amount:

	R
Outgoing distribution	498 000 000
Less: Profits of a capital nature (s 64B(5)(c))	
Capital profit on sale of shares in subsidiaries [not disputed]	(59 824 897)
Capital profit on investment in Appliances [subject of the appeal]	<u>(305 311 541)</u>
Taxable dividend	132 863 562
Less: Incoming dividend from Appliances (s 64B(3)) [not disputed]	<u>(206 080 510)</u>
Net amount (negative)	<u>(73 216 948)</u>

SARS disallowed the exemption in respect of the 'capital profit' determined on disposal of Appliances and determined the net amount as follows:

	R
Net amount (negative) [as determined above]	(73 216 948)
Disallowance of exemption under s 64B(5)(c) in respect of 'capital profit' on 'disposal' of shares in Appliances	305 311 541
Less: Adjustment to capital profit on sale of subsidiaries [not relevant to the appeal]	<u>(1 605 998)</u>
Net amount	<u>230 488 595</u>
STC at 12,5% x R230 488 595	<u>28 811 074</u>

In determining its net amount Defy claimed an STC credit for the incoming dividend that was exempt from STC in Appliances under s 64B(5)(c) of R206 080 509. Defy was entitled to this credit under para (c) of the proviso to s 64B(3) read with s 64B(3A) because it was also being placed in liquidation. Under the law as it presently stands, incoming s 64B(5)(c) dividends are similarly deferred as an STC credit until the recipient is liquidated or deregistered. The only difference between the law at the time of the Defy case is that the prohibition on the claiming of the STC credit was contained in s 64B(3A) and this was later moved into the opening words of s 64B(3). It was not in dispute that Appliances was entitled to the exemption on its outgoing dividend under s 64B(5)(c), nor that Defy was entitled to the credit for this same incoming dividend.

What was in dispute was Defy's claim for an exemption from STC on the pre-CGT capital profit of R305 311 541 which it created by treating the incoming distribution as proceeds on disposal of its shares in Appliances.

Defy had been granted an STC credit under s 64B(3) for the incoming dividend which was exempt from STC in Appliances. By converting the reserves created by this dividend into a pre-CGT capital profit Defy was obtaining 'double favourable treatment', to quote Murphy J in the court *a quo*.¹⁰⁰

Furthermore, Appliances had made an election in respect of revenue reserves of R68 919 491 under s 64B(5)(f) which did not qualify for an STC credit in Defy under s 64B(3A). This portion of the incoming dividend was also treated as proceeds by Defy in order to create a purported STC-exempt capital profit. This would have had the effect of claiming a double exemption in the group, in that Appliances had been relieved of STC on these reserves while Defy would be claiming exemption on the same reserves under s 64B(5)(c) by recharacterising them as an STC-exempt pre-CGT capital profit. This defeated the purpose of s 64B(5)(f) which is to merely defer the payment of STC until the profits in question exit the group.

It is unclear from the facts of the case why the return of share premium received by Defy (R68 811 457) exceeded the cost of the investment in Appliances (R28 451 459). There may have been accumulated losses at the time Appliances was acquired, or the share premium account may have included capitalised profits. Whatever the reason, Defy sought to treat the difference as part of a 'capital profit' calculation.

On the meaning of the term 'profit' as used in s 64B(5)(c)(ii) Nugent JA stated the following:

'Subsection (5)(c)(ii) is concerned with companies that divest themselves of their residual assets in preparation for the dissolution of the company. They do that by converting the assets into cash (or other distributable form), so far as that is necessary, and then distributing the cash to their shareholders. In that context I think it is clear that the word "profit" has meaning 5. assigned to it by the *Shorter Oxford Dictionary* – "the pecuniary gain in any transaction" – and that the transactions to which it relates are the disposal of assets. It goes without saying that the profit so earned will be "of a capital nature" if the asset that yielded the profit was a capital asset. In short, the subsection exempts from taxation the pecuniary gain that is earned upon disposal by the company of a capital asset.'

The court rejected the notion that a capital profit could arise otherwise than from the disposal of an asset. Apart from stating that there were no examples of such a capital profit, the court observed that the decisions on which the appellant had relied (*Bailey v CIR*,¹⁰¹ *New Mines Ltd v CIR*¹⁰² and *ITC 101*¹⁰³) were concerned with whether an amount was of a revenue nature for income tax purposes, while the matter under review was concerned with whether an amount was a capital profit for STC purposes. The court therefore found it unnecessary to determine whether a dividend distributed in anticipation of liquidation was of a revenue or capital nature.¹⁰⁴ The shares in Appliances were still held at the time the amounts were received, and so no asset had been disposed of. The realisation of value was not the same as the disposal of an asset. The court accordingly dismissed Defy's appeal.

c) Pre-residence profits (s 64B(5)(c)(iii))

Also qualifying for exemption upon liquidation, winding up, deregistration or final termination is any distribution of realised or unrealised profits derived by a company before it became a resident.

¹⁰⁰ ITC 1834 (2008) 71 SATC 24 (G).

¹⁰¹ 1933 AD 204, 6 SATC 69.

¹⁰² 1938 AD 455, 10 SATC 9.

¹⁰³ (1927) 3 SATC 324 (U).

¹⁰⁴ On this issue, see the commentary in issue 2 of this Guide and the view of the court *a quo*.

This exemption usually applies when a foreign company becomes a resident as a result of becoming effectively managed in South Africa. It will be necessary for such a company to revalue its assets upon becoming resident so that any unrealised profits can be established on that date. As in the case of pre-1993 profits, SARS will apply the LIFO basis for determining whether any of these pre-entry profits are still in existence at the time the company is liquidated, wound up, deregistered or finally terminated.

3.13.3.5 Steps to liquidate, wind up or deregister

The exemption conferred by s 64B(5)(c) is subject to a number of important conditions.

The 18-month requirement (para (i) of the proviso to s 64B(5)(c))

Within the period stipulated in s 47(6)(c)(i) of declaring the dividend, the company must take the steps set out in s 41(4) to liquidate, wind up or deregister. Under s 47(6)(c)(i) the exemption does not apply to a company that

‘has not, within a period of 18 months after the date of the liquidation distribution, or such further period as the Commissioner may allow, taken the steps contemplated in section 41 (4) to liquidate, wind up or deregister’.

The proviso does not make reference to the final termination of a company’s corporate existence, so would seem not to apply to such a procedure under a foreign law. However, the proviso does apply to the foreign equivalent of a liquidation, winding-up or deregistration (see Tables 2 and 3 below). The company need not necessarily be deregistered or dissolved within the 18-month period, since parts of the process are outside the control of the company. But the process should be initiated by taking the required steps during the period. Companies should ensure that they can take the steps laid down in s 41(4) before declaring dividends in anticipation of liquidation or deregistration. Since the procedure for winding-up and deregistration differ, different steps are specified for these two termination procedures.

Steps to liquidate

The table below sets out the required winding-up or liquidation steps.

Table 1 – Steps under voluntary liquidation

Section 41(4)	Steps to be taken within 18 months of dividend distribution (or within further period allowed by Commissioner)
(a)(i)(aa)	<i>Companies</i> Lodge special resolution under s 200 of the Companies Act
(a)(i)(bb)	<i>Close corporations</i> Lodge written resolution under s 67(2) of the Close Corporations Act 69 of 1984
(a)(i)(cc)	<i>Foreign companies</i> Comply with similar liquidation procedure under foreign law
(a)(ii)	Dispose of all assets and settle all liabilities except for assets required to satisfy any <ul style="list-style-type: none"> • reasonably anticipated liabilities to any sphere of government of any country, and • costs of administration relating to the liquidation or winding-up
(c)	Submit a copy of the required special or written resolution to SARS
(d)	Submit all outstanding returns or information to SARS required under any law administered by Commissioner or obtain the necessary extension from SARS. This must be done by the end of the 18-month period referred to in s 47(6) or by

any extended period allowed by the Commissioner.
--

Under what circumstances will the Commissioner extend the 18-month period for taking the steps in s 41(4)? It is not possible to lay down hard and fast rules, since each case must be judged on its own facts. Requests for extension of the 18-month period which are likely to result in protracted and virtually open-ended delays are unlikely to be greeted sympathetically. Examples of these situations include the disposal of a business when the sale is contingent on results or when the company is engaged in litigation before the commencement of the winding-up period. Obstacles such as these should be settled before placing the company into liquidation. Delays in the winding-up of a company have the effect of deferring the receipt or accrual of a capital distribution in the hands of the shareholders and can therefore be prejudicial to the *fiscus* (see para 77 of the Eighth Schedule).

Steps to deregister

The table below sets out the steps necessary to initiate the deregistration process.

Table 2 – Steps under deregistration

Section 41(4)	Steps to be taken within 18 months of dividend distribution (or within further period allowed by Commissioner)
(b)(i)	<i>Companies</i> Submit written statement signed by all directors confirming that the company has ceased to carry on business and has no assets or liabilities to Registrar of Companies under s 73(5) of the Companies Act.
(b)(ii)	<i>Close corporations</i> As above, but submit to the Registrar of Close Corporations under s 26(2) of the Close Corporations Act.
(b)(iii)	<i>Foreign companies</i> As above, but submit to equivalent of a Registrar, if required under foreign law.
(c)	Submit copy of the required written statement to SARS.
(d)	Submit all outstanding returns or information to SARS required under any law administered by the Commissioner or obtain the necessary extension from SARS. This must be done by the end of the 18-month period referred to in s 47(6) or by any extended period allowed by the Commissioner.

Withdrawal of steps (para (ii) of the proviso to s 64B(5)(c))

The company must not at any stage during the liquidation, winding-up or deregistration process

- withdraw any step taken to liquidate, wind up or deregister, or
- do anything to invalidate any such step so taken, with the result that the company is or will not be liquidated, wound up or deregistered.

Consequences of not meeting the above conditions

The following consequences follow from a failure to meet the above conditions:

First, the company paying the dividend will lose its exemption under s 64B(5)(c).

Secondly, any incoming dividends referred to in s 64B(3)(b) will not be allowed as a deduction in determining the company's net amount. These are dividends that were exempt

in the hands of the distributing company under s 64B(5)(c) and which would otherwise have qualified as a deduction in the hands of, and upon the liquidation, winding-up or deregistration of, the recipient company.

Thirdly, any STC which becomes payable as a result of the failure to meet the conditions is recoverable from the shareholders to whom the dividend was distributed in the same proportion as the dividend was distributed.

3.13.4 Electing gold mining companies (s 64B(5)(e))

Under s 64B(12) a gold mining company can elect to be exempt from STC. The election comes at a price because it will have to pay normal tax at a higher rate than a non-electing gold mining company. Under s 64B(12)(e) the exemption ends with effect from the year of assessment subsequent to the year in which the company ceases to mine for gold. Despite the loss of its exempt status during such subsequent years, s 64B(5)(e) exempts any dividends declared during those subsequent years out of profits on the disposal of gold mining assets.

3.13.5 Intra-group dividends (s 64B(5)(f))

A difficulty with any tax imposed on a dividend is that groups of companies are often arranged in multiple tiers. The tax may then be duplicated as a dividend is received and on-declared to individual shareholders. The STC system addresses this cascading effect. From its inception in 1993 STC has been levied on the net amount of dividends declared and dividends received. STC is thus only levied on dividends declared by companies in the intermediate tiers out of their own profits.

In a multi-tier group structure the lower-tier companies would have to pay STC on dividends declared, since they would not have any incoming dividends with which to reduce their 'net amount'. While an intermediate company would be entitled to a credit for the incoming dividend, there is no guarantee that the dividend will be on-declared immediately, if at all, for example, when the intermediate company has accumulated losses or when it requires the funds for another purpose. If the group is viewed as a single economic unit, dividends should only be taxed when they exit the group at the ultimate parent company level. The up-front taxation of lower-tier group companies may interfere with the efficient allocation of resources within the group and is thus undesirable from an economic efficiency standpoint. In order to address this issue, s 64B(5)(f) was introduced in 1994 to provide that a company declaring a dividend may elect not to pay STC on a dividend paid to a group company. The group company receiving the dividend will then not be permitted to deduct the dividend received when calculating its net amount when declaring a dividend. STC will effectively be levied both on the dividends which it has received and on-declared and those dividends that arise from its own operations.

Under s 64B(5)(f) a company (S) can distribute a dividend STC free to another company (H) when

- H is a shareholder as defined in Part III (s 41 of the corporate restructuring rules),
- H forms part of the same 'group of companies'¹⁰⁵ as defined in s 41 as S,
- The dividend must be taken into account in determining the profits of H.
- H would be subject to STC if
 - it declared a dividend from the dividend declared to it by S, and
 - did not elect the relief provided by s 64B(5)(f),

¹⁰⁵ The term is defined in s 64B(1) and refers to the definition in s 41.

- S elects that s 64B(5)(f) applies to the dividend and submits the election no later than the last day on which the STC would otherwise be due but for s 64B(5)(f) (or no later than any other subsequent date prescribed by the Commissioner), and in such form as the Commissioner may prescribe.

H must be a shareholder as defined in Part III. This is a reference to the definition in s 41(1) which reads as follows:

“**shareholder**” in relation to an equity share, means the registered shareholder of that equity share, unless a person other than that registered shareholder is entitled to all or part of the benefit of the rights of participation in the profits, income or capital attaching to that equity share, in which case that person must, to the extent of that entitlement to that benefit, be deemed to be the shareholder.’

A company will be able to make a s 65B(5)(f) election in respect of dividends declared on shares that do not comprise ‘equity shares’ provided that the shareholder also owns the required percentage of the equity share capital of the company, and complies with the other requirements of s 64B(5)(f).

H and S must form part of the same group of companies. The latter term is defined in s 64B(1) as follows:

“**[G]roup of companies**” means “group of companies” as defined in section 41’.

The definition of a ‘group of companies’ in s 41 applies the definition in s 1, subject to a number of restrictions. For example, it does not include a company that is not a resident, a s 21 company, PBO, recreational club or foreign collective investment scheme. These restrictions are aimed at protecting the STC base, since the excluded companies are not subject to STC.

The term ‘group of companies’ as defined in s 1 reads as follows:¹⁰⁶

“**[G]roup of companies**” means two or more companies in which one company (hereinafter referred to as the “controlling group company”) directly or indirectly holds shares in at least one other company (hereinafter referred to as the “**controlled group company**”), to the extent that—

- at least 70 per cent of the equity shares of each controlled group company are directly held by the controlling group company, one or more other controlled group companies or any combination thereof; and
- the controlling group company directly holds at least 70 per cent of the equity shares in at least one controlled group company.’

Examples – Controlled group company

Facts (1):

H owns 71% of the equity shares in S. Do H and S form part of the same group of companies?

Result (1):

Yes, since H directly holds at least 70% of S.

¹⁰⁶ The required percentage holding was decreased from 75% to 70% with effect from 8 November 2005 by s 3(1)(h) of the Revenue Laws Second Amendment Act 32 of 2005.

Facts (2):

H owns 60% of the equity shares in S and 100% of the equity shares in T. T owns 40% of the equity shares in S. Does H form part of the same group of companies as S?

Result (2):

Yes, since H directly and indirectly holds at least 70% of S. T is a controlled group company in relation to H and can therefore be taken into account in determining whether H holds at least 70% of S directly or indirectly.

Dividend to be taken into account in the determination of the profits of the shareholder

The requirement that the dividend be taken into account in the determination of the profits of the shareholder was originally aimed at pre-acquisition profits, which used to reduce the cost of the investment in subsidiary under GAAP. However, under current GAAP all dividends, including pre-acquisition dividends are now taken directly to income with the result that this provision appears to be ineffective. Furthermore, pre-acquisition dividends are now excluded from the definition of a 'dividend' in s 1 by para (g) of that definition. The requirement therefore seems to be not only ineffective but also superfluous.

Recipient company must potentially be subject to STC

An important requirement for the group relief contained in s 64B(5)(f) is that the dividend recipient be subject to STC if it were to declare a dividend from the dividend that is to be declared to it, assuming that it did not make a s 64B(5)(f) election. In other words, the election is not available to companies that declare dividends to a shareholder that is exempt from STC or is not subject to STC. Permitting the s 64B(5)(f) election under these circumstances would result in a complete and permanent exemption from STC. Examples of shareholders that are exempt from STC include

- a non-resident company,
- a company that is exempt from tax under s 10,
- a tax holiday company, and
- a gold mining company that has elected to be exempt from STC.

Submission of the election

The relief is not automatic and is subject to the submission of a written election that is made on the prescribed form IT56 (Return for payment of secondary tax on companies).¹⁰⁷ This must be submitted by no later than the last day on which the STC would otherwise fall due. That date is set out in s 64B(7) and is the end of the month following the month in which the dividend was declared. For example, if the dividend was declared on 2 June 2010 the IT56 containing the election must be submitted by no later than 31 July 2010. Section 64B(5)(f) does, however, provide the Commissioner with a discretion to extend the period within which the election must be submitted. In evaluating such a request the Commissioner will have to be satisfied that the dividend qualifies under s 64B(5)(f) – for example, it is not being distributed to a non-resident holding company or a resident holding company which holds less than 70% of the subsidiary's shares. A request for such an extension is unlikely to be greeted sympathetically when the recipient company has already applied the dividend in

¹⁰⁷ The form is available from the SARS website at <<http://www.sars.gov.za/home.asp?pid=4153#IT56>> [Accessed 21 September 2010].

question against its own outgoing dividends in determining its net amount. The Commissioner's decision is not subject to objection and appeal as s 64B(5)(f) is not listed in s 3(4) of the Act.

No election for dividend comprising shares in the shareholder (first proviso)

Under s 89 of the Companies Act, a subsidiary is entitled to acquire a maximum of 10% in the aggregate of the number of issued shares of its holding company. This is known as a 'buy-in' of shares (as opposed to a buy-back of shares).

The exclusion of a dividend *in specie* consisting of shares in the parent company is designed to prevent a permanent exemption of profits within a group. In this situation a subsidiary company buys shares in its holding company (STC free) and subsequently distributes those shares to the holding company as a dividend. For details of the accounting treatment of such transactions, see IAS 32 (AC 125) 'Financial Instruments: Disclosure and Presentation' in para 33. IAS 32 provides that no gain or loss must be reflected in the income statement in respect of the cancellation of the shares or consideration received. The amount cancelled must be deducted from equity, and any consideration received must be taken directly to equity. The fact that the accounting entries are not routed through the income statement has no impact for STC purposes because the reduction in the holding company's profits is an outgoing dividend under para (c)(ii) of the definition of a 'dividend' in s 1. The consideration received by the holding company in the form of an incoming dividend remains deductible in determining the holding company's net amount. The exclusion of s 64B(5)(f) incoming dividends under s 64B(3A)(a) does not apply in this instance, since the subsidiary is barred from making an election in respect of the dividend.

Example – Exclusion from s 64B(5)(f) of dividend *in specie* consisting of shares in parent company

Facts:

H is a listed company and owns 100% of S. H originally issued its par value shares of R1 each at a premium of R1. During the year ending 31 December 2006, S purchased 10 000 shares in H on the JSE at a cost of R120 000. S thereafter declared a dividend *in specie* consisting of the H shares to H out of its available profits. Upon receipt of the dividend, H cancelled the shares and passed the following entry:

	R	R
Share capital	10 000	
Share premium	10 000	
Loss on cancellation of shares	100 000	
To Dividend received		120 000

Being own shares acquired from S.

Result:

The subsidiary will not be able to make an election under s 64B(5)(f) and will have to pay STC on a dividend of R120 000. The holding company will be entitled to an allowable incoming dividend of R120 000. Under para (c)(ii) of the definition of a 'dividend' It will also have an outgoing dividend of R100 000 as a result of the reduction of its profits by this amount. The holding company will thus have a negative net amount of R100 000 – R120 000 = -R20 000, represented by the net increase in its profits by the same amount.

No election possible for downward distributions (second proviso)

Under the second proviso to s 64B(5)(f) no election is possible for a dividend declared by a controlling group company to a controlled group company in relation to that controlling group company. In a cross-holding situation this proviso prevents an election for downward distributions. As a result the controlling company will be subject to STC on the outgoing dividend to its controlled group company, while the controlled group company will be entitled to an STC credit. This provision is aimed at a case in which the holding company buys back its shares held by its subsidiary. The entry in the holding company would be, say, Dr Share capital, Dr Reserves Cr Cash. The corresponding entry in the subsidiary would be Dr Cash Cr Investment in holding company. Thus the holding company's profits decrease while there is no corresponding increase in profits in the subsidiary. This is a pre-acquisition dividend in reverse. If the holding company were to be allowed to make an election under s 64B(5)(f) there would be a permanent loss of STC. This measure is not entirely effective because the subsidiary will qualify for an STC credit for the incoming dividend even though its profits have not increased.

3.13.6 Tax Holiday Companies (s 64B(5)(i))

A tax holiday company referred to in s 37H is exempt from STC in respect of any dividend declared

- out of profits derived during the period that the company enjoyed tax holiday status,
- provided that the dividend is distributed within six months of the end of the last year of assessment during which the company enjoyed such status.

It follows that dividends distributed after the six-month window period has ended will not qualify for exemption, nor will profits derived during the six month window. The Commissioner has no discretion to extend the window period.

3.13.7 Distribution of an interest in a residence contemplated in para 51 of the Eighth Schedule (s 64B(5)(k))

Section 64B(5)(k) exempts from STC any dividend declared to a natural person which constitutes the transfer of an interest in a residence contemplated in para 51 of the Eighth Schedule. For more on para 51 see Appendix B of the *Comprehensive Guide to CGT* (issue 3). The STC exemption only applies to the distribution of a residence as a dividend in specie, and not to the distribution of any resulting profit on sale of a residence by a company to a shareholder. Furthermore, the STC relief only applies to the extent that para 51 applies. For example, if a residence is situated on land of four hectares, only a maximum of two hectares will qualify for the relief provided that it is used mainly for domestic or private purposes together with the residence (proviso to para 51(2) read with para 46). The residence must also be transferred to a shareholder who is a natural person. Thus a transfer to a company, trust or the deceased estate of a natural person will not qualify for the STC exemption. The dividend must be declared on or after 11 February 2009 and before 1 January 2012.

3.13.8 Declaration of dividend by a registered micro business (s 64B(5)(l))

Section 64B(5)(l) provides an STC exemption for any dividend declared by any company that is a registered micro business as defined in the Sixth Schedule. The exemption applies during any year of assessment during which the company is a registered micro business, to the extent that the dividend does not exceed the amount of R200 000 during the year.

Example – Dividend declared by a registered micro business*Facts:*

A close corporation registered as a micro business during the year of assessment ending on 28 February 2010. During that year it declared a dividend of R220 000 to its sole member.

Result:

Of the dividend of R220 000, R200 000 will be exempt from STC under s 64B(5)(l), while the remaining R20 000 will be subject to STC at the rate of 10%.

3.14 Time for payment (s 64B(7))

STC must be paid by the last day of the month following the month in which the dividend cycle relevant to the dividend ends. The word 'month' means any of the twelve portions into which a calendar year is divided. Thus the date for payment will always end on the last day of the relevant month, regardless of whether that month has 28, 29, 30 or 31 days. The Commissioner may extend the date for payment. Any decision of the Commissioner in this regard is not subject to objection and appeal under s 3(4).

The payment must be accompanied by an IT56 return.

3.15 Estimated assessments (s 64B(8))

It is not normally necessary for the Commissioner to issue an STC assessment because STC is payable when the prescribed return (IT56) is rendered.

The Commissioner can issue an assessment based on an estimated amount in respect of any unpaid STC when he is satisfied that any amount of STC has not been paid in full. In other words, the Commissioner can raise an assessment when

- the company fails to make a payment, or
- when he is satisfied that an inadequate payment has been made.

In ITC 1740¹⁰⁸ the Commissioner issued a draft STC assessment (IT56A) to a company. As a result of a computer programming error the usual assessment (IT 65B) was never issued. The court upheld the company's appeal on the grounds that a valid assessment had not been issued.

The Commissioner's decision to raise the assessment is not subject to objection and appeal, although the assessment itself will be subject to objection under s 81 read with s 107 and appeal under s 83 (Tax Court) or s 83A (Tax Board) of the Act.

3.16 Prescription (s 79(1))

STC is normally payable on a self-assessment basis, that is, the company submits its payment with an IT56 return and no assessment is issued. However, when not satisfied with the amount paid by the company (if any), the Commissioner is entitled to raise an STC assessment or assessments within the prescribed period. The rules governing the time periods within which STC assessments can be raised are contained in s 79 and are discussed in the three scenarios below.

¹⁰⁸ (2001) 65 SATC 98 (N).

3.16.1 *No assessment issued and STC underpaid*

Under s 79(1)(c) the Commissioner must raise an assessment at any time when he is satisfied

‘that, as respects any tax which is chargeable and has become payable under this Act otherwise than under an assessment, such tax has not been paid in respect of any amount upon which such tax is chargeable or an amount is owing in respect of such tax’.

Under para (ii) of the first proviso to s 79 the Commissioner may not raise an assessment

‘in respect of any tax referred to in paragraph (c), after the expiration of three years from the date of payment of any amount paid in respect of such tax unless—

- (aa) the Commissioner is satisfied that the fact that such tax was not paid in full was due to fraud or misrepresentation or non-disclosure of material facts; or
- (bb) the Commissioner and the taxpayer agree otherwise prior to the expiry of that three year period’.

The ‘date of payment’ is determined under s 79(2A), which reads as follows:

‘For the purposes of paragraph (ii) of the first proviso to subsection (1) the date of payment of any amount referred to in that paragraph shall be deemed to be the date of the official receipt acknowledging the receipt of such amount, and, where more than one such payment was made, the date from which the period of three years referred to in that paragraph shall be reckoned shall be the date of the official receipt acknowledging the latest of such payments.’

Thus when STC has been underpaid the Commissioner must raise an assessment within three years of the date of payment. The three-year period does not apply when there has been fraud, misrepresentation or non-disclosure of material facts or the taxpayer and the Commissioner agree to extend the three-year period.

3.16.2 *No assessment issued and STC not paid (second proviso to s 79(1))*

The second proviso to s 79(1) reads as follows:

‘Provided further that where the Commissioner has in respect of any year of assessment made an assessment upon any company for normal tax purposes, he or she shall not after the expiration of three years from the date of the said assessment (or, where more than one such assessment has been made, from the date of the latest of such assessments), or such longer period as the company and the Commissioner may agree prior to the expiry of that three year period, make any assessment in respect of any amount of secondary tax on companies payable by the company in respect of any dividend declared during that year, unless the Commissioner is satisfied that the fact that an assessment in respect of the said amount was not previously made was due to fraud or misrepresentation or non-disclosure of material facts.’

Thus when the taxpayer has failed to make any payment of STC, the Commissioner must raise an assessment within three years of the later of

- the due date of an original normal tax assessment, or
- when more than one normal tax assessment has been issued, from the due date of the latest of those assessments, or
- such longer period as the company and the Commissioner may agree before the expiry of the three-year period.

The three-year limit does not apply when SARS is satisfied that the fact that an assessment in respect of the said amount was not previously made was due to fraud or misrepresentation or non-disclosure of material facts.

3.16.3 *STC assessment has been raised (s 79(1)(a) and para (i) of first proviso)*

Under s 79(1)(a) the Commissioner must raise an assessment at any time when he is satisfied

‘that any amount which was subject to tax and should have been assessed to tax under this Act has not been assessed to tax’.

Under para (i) of the first proviso to s 79 the Commissioner may not raise an assessment

‘after the expiration of three years from the date of the assessment (if any) in terms of which any amount which should have been assessed to tax under such assessment was not so assessed or in terms of which the amount of tax assessed was less than the amount of such tax which was properly chargeable, unless—

- aa) the Commissioner is satisfied that the fact that the amount which should have been assessed to tax was not so assessed or the fact that the full amount of tax chargeable was not assessed, was due to fraud or misrepresentation or non-disclosure of material facts; or
- bb) the Commissioner and the taxpayer agree otherwise prior to the expiry of that three year period’.

Thus the general rule is that an additional STC assessment must be raised within three years of the due date of the assessment¹⁰⁹ in which the amount should have been assessed to STC unless

- there has been fraud, misrepresentation or non-disclosure of material facts; or
- the commissioner and the taxpayer agree to extend the three-year period before it has expired.

Example 1 – Prescription

Facts:

A company with a February financial year end declares a dividend on 1 July 2008 and pays the related STC on 31 August 2008. The due date of the normal tax assessment for 2009 is 1 November 2009 and no other normal tax assessments have been raised in respect of that year. When would the assessment prescribe, assuming that the company

- paid no STC on the dividend, or
- underpaid the STC on the dividend?

Assume that the company properly completed an IT56 return in both cases and that the dividend was disclosed in the 2009 return of income (IT14).

Result:

STC not paid: Since no STC has been paid there will be no receipt in respect of a payment. Accordingly, the second proviso to s 79 applies, and the STC assessment must be raised within three years from the due date of the normal tax assessment, namely, 1 November 2009, that is, by 31 October 2012.

¹⁰⁹ See the definition of ‘date of assessment’ in s 1.

STC underpaid: Under s 79(1)(c) read with para (ii) of the first proviso SARS must raise the assessment within three years of the date of the official receipt (31 August 2008), that is, by 30 August 2011.

Example 2 – Prescription

Facts:

The facts are the same as above, except that SARS raised an additional normal tax assessment on the company in respect of the 2009 tax year, due date 1 October 2012.

Result:

STC not paid: The Commissioner must raise the STC assessment within three years of the due date of the additional assessment (1 October 2012), that is, by 30 September 2015.

STC underpaid: The result is the same as in Example 1.

When an additional normal tax assessment has been issued, the second proviso to s 79(1) does not require a causal link between that assessment and any STC liability that may arise. The three-year period simply starts to run from the due date of the revised assessment. There could, for example, be a link in the case of a s 31 transfer pricing adjustment which is also deemed to be a dividend under s 64C(2). But as stated, such a link is not a requirement and the effect is to give the Commissioner more time in which to assess the company's STC liability when no STC payment has been made by the company.

Under the exception to the general rule, the Commissioner is permitted to raise an assessment or additional assessment after the three-year period described above has elapsed when he or she is satisfied that the fact that an assessment in respect of the amount was not previously made was due to fraud or misrepresentation or non-disclosure of material facts.

When an assessment is issued after three years, it is imperative for the Commissioner to notify the company that he or she is satisfied that there has been fraud, misrepresentation or non-disclosure of material facts and that as a result thereof, the assessment was not raised within the three-year period. Furthermore, the Commissioner must inform the taxpayer of which one of the three types of conduct he or she is satisfied has taken place (that is, whether it was fraud, misrepresentation or non-disclosure of material facts). See in this regard *Natal Estates v SIR*.¹¹⁰ According to ITC 1776 discussed below, the Commissioner must also explain to a taxpayer the basis for arriving at a conclusion that fraud, misrepresentation or non-disclosure of material facts has occurred.

ITC 1740 discussed in 3.15 had a sequel in ITC 1776.¹¹¹ The Commissioner subsequently issued the assessment and advised the company that the reason why it had not been raised within three years was due to fraud, misrepresentation or non-disclosure of material facts. The court upheld the appeal on the basis that

- the Commissioner had not advised the company which of its actions (fraud misrepresentation or non-disclosure) had resulted in the non-assessment within three years,
- the Commissioner had also not advised the company of the basis for his conclusion, and

¹¹⁰ 1975 (4) SA 177 (A), 37 SATC 193 at 225.

¹¹¹ (2003) 66 SATC 296 (N).

- the reason why the assessment had not been timeously raised was as a result of the computer processing error which resulted in the failure to issue a valid assessment in the first place (the original assessment was merely a draft).

In order to discharge the onus of proving that adequate disclosure has been made, the company must have lodged a fully completed IT56 return when it declared a dividend, including a deemed dividend.

3.17 Interest on unpaid STC (s 64B(9))

Interest is payable at the prescribed rate on any unpaid STC from the date on which the amount was due (see s 64B(7)).

3.18 Administration and additional tax (s 64B(11))

Under s 64B(11) the provisions of the Act relating to the assessment and recovery of

- normal tax, and
- additional tax in the event of default or omission,

apply equally for STC purposes. It is further provided that these provisions must be adapted in the context of STC. Since s 64B(11) only deals with matters pertaining to assessment and recovery, it does not extend to claims for the payment of interest on refunds of STC. In *Sage Life Ltd v Minister of Finance & another*¹¹² the court held that the Commissioner was in *mora ex persona* as from the date when the demand to pay interest was made and it followed that the taxpayer would be entitled to interest at the applicable rate as from that date. It was further held that the common law principles of *mora* applied to the Commissioner and debts due by him to taxpayers.

The court also held that the taxpayer was entitled to rely on the 30-year prescription period provided for in respect of tax debts in s 11(a)(iii) of the Prescription Act 68 of 1969. But the SCA rejected this latter interpretation as a 'forced interpretation' of s 11(a)(iii) in *Eskom v Bojanala Platinum District Municipality & another*,¹¹³ holding that the provision only operated in favour of the State.

3.19 Gold mining companies (s 64B(12))

Companies that mine for gold can elect to be exempt from the payment of STC by submitting a written notice to the relevant SARS office. The notice must be submitted by no later than the following dates:

¹¹² (2001) 66 SATC 181 (T).

¹¹³ 2005 (4) SA 31 (SCA).

Table 1 – Dates by which election must be submitted

Section 64B(12)	Company	Deadline for submission of notice
(a)	Engaged in gold mining on 17 March 1993	31 August 1993
(b)	Commencing gold mining after 17 March 1993	Six months after commencing gold mining

The election is binding in respect of all future dividends declared by the company (s 64B(12)(c)). The exemption applies to all dividends, even if declared from profits derived from non-gold mining activities (s 64B(12)(d)).

The election to be exempt from STC was introduced to cater for marginal gold mines that were not liable for normal tax, but would have become liable for STC had the election not been available. Companies that make the election are taxed under a different formula to those who have not made the election.

When an electing company ceases to mine for gold during a year of assessment, the exemption will cease to apply to any dividends declared during any subsequent year of assessment (s 64B(12)(e)).

3.20 Limitation on allowable incoming dividends received by or accrued to long-term insurers (s 64B(13))

Under s 29A(3) of the Act, long-term insurance companies are obliged to form four separate funds, namely, the corporate fund, company policyholder fund, individual policyholder fund and untaxed policyholder fund. The corporate fund represents the interests of the shareholders while the other three funds represent the interests of policyholders.

Under s 64B(13) a long-term insurance company is only entitled to claim an STC credit for dividends accruing on shares held as assets by its corporate fund.

3.21 Preference on winding-up

Under s 101(a) of the Insolvency Act 24 of 1936, SARS enjoys a preferent claim in respect of STC arising before the date of liquidation since it comprises

‘any tax on persons or the incomes or profits of persons . . .’.

STC arising in respect of dividends declared after the date of liquidation is treated as a cost of administration under s 97(2)(c) of the Insolvency Act.¹¹⁴

While a degree of preference may have significance in a compulsory winding-up, it has no effect in a voluntary winding-up, since in the latter case all creditors must be paid, whether they are pre- or post-liquidation creditors.¹¹⁵

¹¹⁴ *Van Zyl NO v CIR* [1997] 1 All SA 340 (C), 59 SATC 105 at 113/114.

¹¹⁵ Section 350(1)(b)(i) of the Companies Act.

Chapter 4 – Deemed dividends

4.1 Quick reference guide to s 64C

Table 1 – Quick reference guide to s 64C

Section 64C	Topic	Description
(1)	Definitions	'Share incentive scheme'
(2)	Deemed dividends	
(a)		Distribution or transfer of cash or assets to shareholder / connected person in relation to shareholder
(b)		Release from obligation to company
(c)		Settlement or payment of debt of shareholder / connected person
(d)		Amounts applied / used by company for benefit of shareholder / connected person in relation to shareholder
(e)		Transfer pricing and thin capitalisation adjustments under s 31
(f)		Cessation of residence
(g)		Loan or advance to shareholder / connected person in relation to shareholder
(h)		Hybrid debt instrument under s 8F
Proviso		For purposes of s 64C(2), in determining whether a person is a shareholder in relation to any company, no regard must be had to any share that is a listed share.
(3)	Deleted	
(4)	Exclusions	
(a)		Dividends as defined in s 1 without exclusions (e) – (i)
(b)		Shareholder's remuneration and repayment of amounts owed to shareholders / connected persons
(bA)		Consideration received in exchange for assets / benefits
(c)		Amounts in excess of profits available for distribution
(d)		Loans bearing interest at or above the official rate
(e)		Loans to employees
(f)		Once-off concession in respect of loans repaid before end of following tax year
(g) & (h)		Deleted
(i)		Loan to employee share purchase trust
(j)		Deleted
(k)		Certain deemed dividends to shareholder or connected person in relation to shareholder forming part of same group of companies as distributing company
(l)		Certain deemed dividends made by a company in which the company making the distribution holds an interest of at least 20% together with other group companies (no cross holding permissible) (downward distribution)
(5)	Loan repayments	Repayment of loan treated as a dividend is deemed to be an incoming dividend for the purposes of s 64B
(6)	Time of declaration of deemed dividend	This subsection sets out the date when a deemed dividend is deemed to be declared. This is required for determining the end of the dividend cycle

4.2 Definition – ‘share incentive scheme’ (s 64C(1))

“**[S]hare incentive scheme**” means a scheme in terms of which not more than 20 per cent of the equity share capital of a company is—

- (a) held by the directors and full-time employees of—
 - (i) such company; or
 - (ii) an associated institution, as defined in paragraph 1 of the Seventh Schedule, in relation to such company,
 in terms of a share incentive scheme carried on for their own benefit;
- (b) held by a trustee for the benefit of such directors and employees under a scheme referred to in section 38(2)(b) of the Companies Act, 1973 (Act 61 of 1973); or
- (c) collectively held by such directors and full-time employees, and such a trustee.’

This definition is relevant for the purposes of the s 64C(4)(i) exemption in respect of loans to employee share purchase trusts.

4.3 Deemed dividends (s 64C(2))

4.3.1 Introduction

Section 64C(2) deems certain amounts to be dividends declared by a company to a shareholder for the purposes of s 64B. In essence s 64C is an anti-avoidance measure.

The amounts that have been deemed to be dividends under s 64C(2) are subject to s 64C(4), which sets out what is excluded as a deemed dividend. Under some of these inclusions an amount can be deemed to be a dividend even though it may not have been distributed or transferred to the actual shareholder of the company. It follows that sideways (for example, to a fellow subsidiary) or even downward (for example, from a subsidiary to a sub-subsidiary) flows of funds in a group structure can trigger a deemed dividend, even though in reality such amounts could never be declared as a ‘real life’ dividend. At first glance this may seem illogical, but such rules are very necessary to counter STC avoidance. Cash or assets can easily be moved around a group of companies, and amounts could be routed to a shareholder indirectly.

Example – Sideways distribution

Facts:

Holdco owns 69% of Sub 1 and 69% of Sub 2. Sub 1 has R10 million in cash and a like amount of profits available for distribution. It would like to distribute the cash to Holdco without declaring a formal dividend or by simply lending the money to Holdco. Sub 2 has an accumulated loss. Sub 1 lends the R10 million to Sub 2 which on-lends it to Holdco.

Result:

The loan from Sub 1 to Sub 2 is a deemed dividend under s 64C(2)(g), since Sub 2 is a connected person in relation to Holdco. Had Holdco owned at least 70% of Sub 1, the exemption in s 64C(4)(k) may have applied.

When dealing with deemed dividends between companies, the exemptions in s 64C(4)(k) and (l) should be borne in mind. Whether these exemptions will apply will depend on, amongst others, the percentage shareholdings involved.

A motive or purpose of STC avoidance is not a prerequisite for the application of s 64C.

4.3.2 Distribution or transfer of cash or assets (s 64C(2)(a))

A deemed dividend arises when cash or an asset is

- distributed, or
- transferred

by the company for the benefit of

- the shareholder, or
- any connected person in relation to the shareholder.

This provision does not include loans to shareholders and connected persons in relation to shareholders as these are included by para (g). The word 'distribution' is not defined. In distinguishing it from the word 'declared', Dr Manfred Nathan KC stated the following in ITC 356¹¹⁶:

'The ordinary meaning of the word "distributed" to our mind seems to be the paying out of the amount in question to each shareholder, and the receipt by him of that amount.'

Furthermore, it is submitted that a distribution relates to something given to a shareholder without imposing an obligation to return it.

The 'transfer' of an asset in exchange for a market-related consideration would not fall within s 64C(2)(a), since it would not confer a benefit on a shareholder or connected person in relation to a shareholder.

Share block conversions

The granting of an indefinite right of use and occupation to a shareholder upon conversion of a company to a share block company as envisaged in the Share Blocks Control Act 59 of 1980 will result in a deemed dividend under s 64C(2)(a) to the extent of any realised or unrealised profits. Any unrealised profits must be taken into account regardless of whether they have been recognised in the financial records of the company (see third proviso to the definition of a 'dividend' in s 1).¹¹⁷

Example – Conversion of company to share block company

Facts:

ABC (Pty) Ltd's balance sheet appeared as follows:

	R
Share capital (10 shares of R1 each)	10
Mortgage bond	<u>100 000</u>
	<u>100 010</u>
Land and buildings – at cost	100 000
Cash	<u>10</u>
	<u>100 010</u>

¹¹⁶ (1936) 9 SATC 95 (U).

¹¹⁷ 'STC – Shareblock Conversions' (October 1994) *Integritax* in para 96 at 10.

The land and buildings consist of a block of 10 flats. The shares in the company were owned by a property developer who decided to convert the company to a share block company as contemplated in the Share Blocks Control Act. At the time of the conversion, the right of use and occupation was valued at R1 000 000. Under the conversion each shareholder acquired 1 share which incorporated a right of use and occupation of a designated flat, lock-up garage and servant's quarters for an unlimited period. Before conversion the developer settled the mortgage bond, and the amount settled was credited to the developer's loan account. Each shareholder paid R100 000 to the developer, being R10 000 in respect of a cession of a portion of the developer's loan account and R90 000 in respect of each share which incorporated the right of use and occupation. After the transaction, but before accounting for any STC liability, the company's balance sheet appeared as follows:

	R
Share capital	10
Shareholders' loans	<u>100 000</u>
	<u>100 010</u>
Land and buildings – at cost	100 000
Cash	<u>10</u>
	<u>100 010</u>

The company's accountant decided to adopt the cost model in accounting for the property.

Result:

Immediately before the conversion the company had an unrealised profit of R900 000 available for distribution, even though this was never reflected in the financial statements. The granting of the right of use and occupation to the shareholders is regarded as a deemed dividend under s 64C(2)(a) in that it represents the transfer of an asset (the right of use and occupation) to the shareholders. The amount that is subject to STC is limited to R900 000, being the unrealised profit available for distribution. The STC payable is therefore R900 000 x 10% = R90 000.

Connected person

In assessing whether a person is a connected person in relation to a shareholder, regard must be had to the definition of 'connected person' in s 1. In the context of group structures para (d) of the definition sets out who is a connected person in relation to a company. Some examples are illustrated in the table below. These are by no means exhaustive.

Table 1 – Examples of connected persons in relation to a company

Paragraph (d) of definition of connected person in s 1	Example	Result
(i)	H holds 51% of the equity shares in S. Is H a connected person in relation to S?	Yes, H would be the controlling group company of S if the definition of a 'group of companies' in s 1 used the expression 'more than 50%' instead of 'at least 70%'.
(i)	H owns 51% of S and S owns 51% of T. Is T a connected person in relation to H?	Yes, H, S and T would all be members of the same 'group of companies' as defined in s 1 if that definition used the expression 'more than 50%' instead of

		'at least 70%'.
(i)	H owns 51% of S and 51% of T. Is S a connected person in relation to T?	Yes, since H, S and T would all be part of the same 'group of companies' as defined in s 1 if that definition used the expression 'more than 50%' instead of 'at least 70%'.
(iv)	Individual owns 20% of H. Is Individual a connected person in relation to H?	Yes, since Individual owns at least 20% of H's equity share capital or voting rights.
(v)	H, X, Y and Z (all companies) own the following interests in the equity share capital and voting rights in S: H – 20% X – 50% Y – 15% Z – 15% Are H, X, Y and Z connected persons in relation to S?	Only H and X are connected persons in relation to S, as they hold at least 20% of the shares and no shareholder owns > 50% of the voting rights.
(vA)	Individual owns 100% of S and T. Is S a connected person in relation to T?	Yes, since T is controlled by Individual and S is a connected person in relation to Individual.
(vi)	Individual owns 10% of ABC CC. Is Individual a connected person in relation to ABC CC?	Yes, every member of a close corporation is a connected person in relation to that close corporation, regardless of the size of that member's interest.

4.3.3 Release from obligation to company (s 64C(2)(b))

A dividend is deemed to be declared when

- the shareholder or any connected person in relation to the shareholder
- is released or relieved from any obligation measurable in money
- which is owed to that company by that shareholder or connected person
- to the extent that the amount so owed has not already been deemed to be a dividend under s 64C(2)(g).

The term 'measurable in money' is not defined but probably refers to an obligation that can be readily quantified in monetary terms. While virtually any obligation, except perhaps a moral obligation, can be quantified by estimation, it would seem that the term does not have such a wide meaning. For example, it would probably not include the release from an obligation under a personal service contract in which the shareholder had not yet rendered the future services and had not been paid therefor. This inclusion does not include the waiver of a loan or advance owed to the company to the extent that it has already been deemed to be a dividend under s 64C(2)(g).

Example – Release from obligation*Facts:*

In 2007 ABC CC advanced R100 000 to its sole member. During that year the close corporation had an accumulated loss and the Commissioner was unable to deem the loan to be a dividend under s 64C(2)(g) because of the exclusion in s 64C(4)(c) (insufficient reserves).

During the 2010 year of assessment the CC waived R50 000 of the loan. At that point ABC CC had reserves in excess of R50 000.

Result:

ABC CC is deemed to have declared a dividend of R50 000 for STC purposes.

4.3.4 Settlement of debt (s 64C(2)(c))

A deemed dividend will arise when the company pays or settles a debt owed to a third party by the shareholder or a connected person in relation to the shareholder.

Example – Settlement of third party debt*Facts:*

S is the sole shareholder of XYZ (Pty) Ltd. During December 2009 S went on a shopping spree and ran up a personal bill of R10 000 at a clothing store. XYZ (Pty) Ltd settled S's account on 28 February 2010. The company's reserves available for distribution exceeded R10 000.

Result:

The company is deemed to have declared a dividend of R10 000 under s 64C(2)(c) for STC purposes.

4.3.5 Amounts applied / used by company for benefit of shareholder / connected person in relation to shareholder (s 64C(2)(d))

A deemed dividend arises when any amount is used or applied by the company in any other manner for the benefit of the shareholder or any connected person in relation to that shareholder.

This inclusion covers amounts used or applied in a more indirect manner for the benefit of a shareholder or connected person in relation to a shareholder. This could take the form of a service to be rendered by a third party or an asset to be supplied by a third party. A company rendering a service will, it would seem, have an 'amount' equal to the cost of rendering the service. The cost to the company represents the amount by which its profits have been reduced. The rendering of a service must, however, be distinguished from the distribution of an asset *in specie* which must be accounted for at market value. Transfers of assets of the company are not addressed by this inclusion, but by s 64C(2)(a).

Example – Amounts used or applied for shareholder’s benefit*Facts:*

L is a shareholder, but not a director or employee of ABC (Pty) Ltd. On 30 June 2009 the company paid a pool company an amount of R20 000 to install a swimming pool at L’s house. The company’s reserves available for distribution exceeded R20 000.

Result:

The company is deemed to have declared a dividend of R20 000 for STC purposes under s 64C(2)(d).

4.3.6 Transfer pricing adjustments (s 64C(2)(e))

A dividend is deemed to arise if a transaction with the shareholder or connected person in relation to the shareholder occurs under s 31 of the Act (transfer pricing and thin capitalisation). The amount of the dividend is the increase in the company’s taxable income or reduction in its assessed loss and covers the

- adjustment of a consideration under a transfer pricing adjustment, or
- the disallowance of interest, finance charges or other consideration under the thin capitalisation rules.

Under a strict interpretation of the wording of s 31(3), a taxpayer cannot make an adjustment for excessive financial assistance, since such an adjustment must be made by the Commissioner. However, a taxpayer may make a voluntary adjustment to taxable income to account for financial assistance in excess of the 3:1 ratio laid down by the Commissioner as a guideline and disclose this in the income tax return. The issue of an assessment in accordance with such a return must be taken as confirmation by the Commissioner of the adjustment.

But the Commissioner’s discretion will not have been exercised through the mere issue of an assessment at face value based on a return reflecting an adjustment applying a ratio higher than 3:1. In ITC 1480¹¹⁸ the Commissioner had issued a ruling to the appellant that certain capital allowances could be based on an amount equal to the cash cost of the asset plus finance charges not exceeding the cash cost. The taxpayer submitted a return of income claiming the allowances on an amount which included finance charges in excess of 100% of the cash cost. The taxpayer argued that by issuing an assessment in accordance with the return of income submitted, the Commissioner had exercised his discretionary powers. The issue before the court was whether the Commissioner was precluded by section 3(2) from issuing revised or additional assessments under section 79. Before the issue of the taxpayer’s original assessment, nobody, neither the Commissioner nor any of his officials had come to a decision on a discretionary matter within the Commissioner’s powers, nor had the taxpayer’s contentions enjoyed any decision by the Commissioner or his officials. It was held that the assessment did not give effect to any such decision, since there was in fact no decision, and the result was that the Commissioner was not prevented by section 3(2) from issuing an additional assessment.

The determination of the excessive portion of interest, finance charge or other consideration and the exercise of the Commissioner’s discretion will usually be made at the time the assessment is raised in which the excessive portion is disallowed as a deduction. The dividend cycle for the deemed dividend will, for purposes of the definition of “dividend cycle” in section 64B(1), be regarded as ending on the due date of the assessment. However, if the

¹¹⁸ ITC 1480 (1988) 52 SATC 276 (N).

taxpayer is notified in writing by the Commissioner of the amount so disallowed before the date of assessment, the dividend cycle will be regarded as ending one month after the date of that notification.

Example – Transfer pricing adjustment

Facts:

Holdco, a company resident in Jersey, owns all the shares in Subco, a South African-based manufacturing company. During the year ended 28 February 2010 Subco sold 100 000 widgets to Holdco at a price of R2 per widget when the arm's length market price was R5 per widget. Holdco also charged Subco interest at the rate of 20% a year when the prevailing arm's length rate was 7%. The amount of Holdco's loan to Subco was constant throughout the year at R10 000 000. Following on a SARS transfer pricing audit, Subco's taxable income was adjusted under s 31 as follows:

	R
Understatement of sales to Holdco (100 000 x (R5 – R2))	300 000
Excessive interest charged on loan (R10 000 000 x (20% – 7%))	<u>1 300 000</u>
Increase in taxable income	<u>1 600 000</u>

Result:

Subco is deemed to have declared a dividend of R1 600 000 for STC purposes under s 64C(2)(e).

4.3.7 Cessation of residence (s 64C(2)(f))

When a company ceases to be a resident all its profits and reserves available for distribution immediately before cessation of residence are deemed to be a dividend declared. In determining those profits and reserves

- any profits deemed to be available for distribution under the definition of 'dividend' in s 1 must be taken into account (for example, reserves transferred to the share premium account or capitalisation shares issued out of profits), and
- any restriction on distribution in the company's memorandum and articles of association, founding statement or agreement must be disregarded.

A company could cease to be a resident of South Africa if it is a foreign incorporated company and changes its place of effective management from South Africa to an offshore jurisdiction. Alternatively, a company formed in South Africa could change its residence as a result of the application of the tie breaker rules of a double taxation agreement.

In determining the amount of profits and reserves that a company has available for distribution upon ceasing to be a resident, unrealised profits and losses must be taken into account (see in this regard the definition of 'profit' in s 64B(1) read with the third proviso to the definition of a 'dividend' in s 1).

Example – Cessation of residence

Facts:

ABC Inc, a company formed in the British Virgin Islands operates in South Africa. It changed its place of effective management on 1 March 2010 from Johannesburg to the British Virgin Islands. On 28 February 2010 the company's balance sheet appeared as follows:

<i>Capital employed</i>	R
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Share capital (100 000 shares of R1 each)	100 000
Non-distributable reserves	60 000
Distributable reserves	<u>80 000</u>
	<u>240 000</u>

The company's share capital includes an issue of 50 000 capitalisation shares that were paid up out of distributable reserves. The non-distributable reserves consist of capital profits on the sale of land and buildings. Under the company's founding statement it is not permitted to distribute such profits except on liquidation.

Result:

ABC Inc is deemed to have declared a dividend of R190 000 made up as follows:

	R
Capitalisation shares	50 000
Non-distributable reserves	60 000
Distributable reserves	<u>80 000</u>
	<u>190 000</u>

The capitalisation shares constitute an amount available for distribution under the definition of a 'dividend' in s 1. The non-distributable reserve is regarded as available for distribution as the restriction contained in the founding statement must be disregarded under s 64C(2)(f).

4.3.8 Loan or advance (s 64C(2)(g))

A dividend is deemed to arise when a loan or advance is granted or made available to a shareholder or connected person in relation to the shareholder.

Some practical difficulty may be experienced when a company makes numerous advances to a shareholder during the tax year. For example, if the company makes 365 advances during a tax year, must it submit 365 IT56 forms? Since STC is only payable at the end of the month following the declaration of a dividend, it would be acceptable to group advances made during a month together and submit one return per month.

Section 64C does not make provision for the available profits to be reduced by the amount of deemed dividends in prior years. It is therefore possible for more than one deemed dividend to be declared out of the same profits.¹¹⁹

Furthermore, when a loan is deemed to be a dividend out of available reserves and an actual dividend is subsequently declared out of those same reserves, the actual dividend will also be subject to STC. However, any repayment of a loan that was deemed to be a dividend under s 64C(2)(g) is deemed to be an incoming dividend under s 64C(5). If a deemed dividend has arisen as a result of a debit loan account, and an actual dividend is subsequently credited to the loan account, the actual dividend will be shielded from STC, since the repayment of the loan gives rise to a deemed incoming dividend. This is illustrated in the example below.

¹¹⁹ This was confirmed in an unreported decision of the Natal Special Board, case 0039 dated 28 March 2001. The view is shared by D Meyerowitz 'Secondary Tax on Companies: Another Look' (1993) 42 *The Taxpayer* 1423 and M L Stein 'STC Anomalies' (1994) 8 *Tax Planning* 67.

Example 1 – Loan or advance to shareholder*Facts:*

C is the sole shareholder of ABC (Pty) Ltd and is neither a director nor an employee of the company. The company advanced C the following amounts interest free on loan account:

	Advance	Loan Balance
	R	R
Year 1	100 000	100 000
Year 2	100 000	200 000

The company's reserves available for distribution at the beginning of year 1 amounted to R150 000, and its net income after normal tax was nil in years 1 and 2.

Result:

Under s 64C(2)(g) the company is deemed to have declared a dividend of R100 000 in year 1 and a further dividend of R100 000 in year 2. In each year there were reserves available for distribution in excess of R100 000. The company's reserves are not reduced by the deemed dividends.

Example 2 – Loan or advance to shareholder followed by declaration of actual dividend*Facts:*

The facts are the same as in Example 1. In year 3 the company declared an actual dividend to C of R100 000. In that year the company's net income after normal tax was nil.

What are the consequences if the actual dividend is

- paid in cash, or
- credited to C's loan account?

Result:

If the amount is paid in cash it will be subject to STC. The company's reserves are not reduced by the deemed dividends declared in years 1 and 2. The position may be summarised as follows:

Pay dividend in cash

	Year 1	Year 2	Year 3
	R	R	R
<i>Capital employed</i>			
Retained income brought forward	150 000	140 000	130 000
Profit after normal tax	-	-	-
Actual dividend	-	-	(100 000)
Less: STC	<u>(10 000)</u>	<u>(10 000)</u>	<u>(10 000)</u>
Retained income carried forward	<u>140 000</u>	<u>130 000</u>	<u>20 000</u>

Employment of capital

Loan to C	100 000	200 000	200 000
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STC calculation:

Outgoing dividend	100 000	100 000	100 000
Incoming dividend	-	-	-
Net amount	<u>100 000</u>	<u>100 000</u>	<u>100 000</u>
STC	10 000	10 000	10 000

Credit dividend to loan account

The amount credited to C's loan account will result in an outgoing dividend. However, the resulting part-repayment of the loan will also trigger a deemed incoming dividend under s 64C(5). The net amount will therefore be nil (incoming dividend of R100 000 less dividend declared of R100 000). The position is therefore as follows:

	Year 1	Year 2	Year 3
	R	R	R
<i>Capital employed</i>			
Retained income brought forward	150 000	140 000	130 000
Profit after normal tax	-	-	-
Actual dividend credited to loan account	-	-	(100 000)
Less: STC	<u>(10 000)</u>	<u>(10 000)</u>	<u>-</u>
Retained income carried forward	<u>140 000</u>	<u>130 000</u>	<u>30 000</u>
<i>Employment of capital</i>			
Loan to C	100 000	200 000	100 000
STC calculation:			
Outgoing dividend	100 000	100 000	100 000
Deemed incoming dividend	<u>-</u>	<u>-</u>	<u>(100 000)</u>
Net amount	<u>100 000</u>	<u>100 000</u>	<u>-</u>
STC	10 000	10 000	-

In *C: SARS v Dyefin Textiles (Pty) Ltd*¹²⁰ a company set up a trust for the purpose of awarding its shares to employees at a future date. The company advanced funds to the trust in order that it could acquire the shares in the company. The company was listed as a beneficiary in the trust deed, although the trustees held the shares. Upon instructions from the directors of the company the trustees were obliged to award the shares to nominated third parties. The court rejected the argument that the company was a shareholder in itself and therefore could not lend money to itself. It held that the trust was a shareholder and that the loan was deemed to be a dividend under s 64C.

Loans to subsidiaries by holding companies

Not all downward distributions will constitute a deemed dividend in a group context. One of the requirements of s 64C(2)(g) is that the loan must be to a shareholder or connected person in relation to a shareholder. The latter requirement may not be met in all circumstances.

Example 3 – Downward loan not deemed to be a dividend*Facts:*

Holdco's issued equity share capital comprises 1 000 shares of R1 each. Each of its shareholders holds 10% of the equity shares and voting rights in Holdco. None of the shareholders are connected persons in relation to each other or are part of the same group of companies as Holdco

Holdco lends Subco, a wholly owned subsidiary, an amount of R100 000 interest free at a time when Holdco's reserves exceed that figure.

¹²⁰ *C: SARS v Dyefin Textiles (Pty) Ltd* 2002 (4) SA 606 (N), 65 SATC 126.

Result:

The loan is not made to a shareholder of Holdco, but the question is whether it is made to a connected person in relation to Holdco's shareholders.

The loan is not a deemed dividend under s 64C(2)(g) since Subco is not a connected person in relation to the shareholders of Holdco. Under para (d)(i) and (iv) of the definition of a 'connected person' in s 1 Holdco is not a connected person in relation to any of its shareholders.

4.3.9 Hybrid debt instrument (s 64C(2)(h))

A company is denied a deduction of interest incurred in respect of a hybrid debt instrument contemplated in s 8F of the Act. In simple terms this is a loan that can be converted to equity shares within three years of issue. In essence s 8F treats the instrument as a share and the interest paid as a dividend. Under s 64C(2)(h) the disallowed interest under s 8F is treated as a dividend declared for STC purposes.

4.3.10 Proviso to s 64C(2)

For purposes of s 64C(2), in determining whether a person is a shareholder in relation to any company, no regard must be had to any share that is a listed share.

Transactions with listed shares are removed from the ambit of s 64C(2) because the governance rules associated with listed shares effectively prevent disguised dividends. As a result, if a listed company makes a loan to a listed shareholder at a rate below the official rate, s 64C does not apply because the listed shareholder is not viewed as a shareholder for purposes of s 64C.

4.4 Exclusions (s 64C(4))

An amount will not be deemed to be a dividend under s 64C(2) in the following circumstances:

4.4.1 Defined dividends (s 64C(4)(a))

An amount will not be deemed to be a dividend when

- it constitutes a dividend, or
- would have constituted a dividend but for paras (e) to (i) of the definition of 'dividend' in s 1.

The amounts referred to in paras (e) to (i) of the definition of a 'dividend' are specific exclusions, namely

- the distribution of capitalisation shares out of the share premium account (para (e)),
- the repayment of 'pure' share capital or share premium, that is, share capital or share premium that has not been tainted by the transfer of profits to share capital or the share premium account (para (f)),
- a pre-acquisition dividend distributed by a company forming part of the same 'group of companies' as defined in s 41 (para (g)),
- the nominal value of capitalisation shares issued as part of equity share capital (para (h)), and
- certain amounts distributed by co-operatives (para (i)).

The purpose of this provision is to avoid double taxation and to ensure that the specific exclusions from the definition of 'dividend' are not deemed to be dividends under s 64C.

4.4.2 Shareholder's remuneration and repayment of amounts owed to shareholders (s 64C(4)(b))

Excluded as dividends are

- any amount constituting remuneration in the hands of the shareholder or any connected person in relation to the shareholder, and
- any settlement of debt owed by the company to the shareholder or connected person.

Section 64C(2)(a) is framed in wide terms and could include contributions made by a company to an employee's pension, provident or medical scheme when the employee is also a shareholder or connected person in relation to a shareholder. For the purposes of s 64C(4)(b) the word 'remuneration' must be given its ordinary meaning and therefore includes any payments forming part of the employee's remuneration package.¹²¹ Employer contributions to employees' pension, provident and medical scheme will accordingly not be deemed to be dividends declared by the company.

4.4.3 Consideration received in exchange for assets/benefits (s 64C(4)(bA))

A deemed dividend will not arise to the extent of any consideration received by the company in exchange for

- the cash or asset distributed, transferred or otherwise disposed of, or
- any other benefit granted as contemplated in s 64C(2).

The purpose of this provision is to ensure that a debt arising from an arm's length transaction such as a trade debt arising from a sale of goods or the provision of a service is not deemed to be a dividend.

4.4.4 Amounts in excess of profits available for distribution (s 64C(4)(c))

An amount will not be deemed to be a dividend to the extent that it exceeds the company's profits and reserves which are available for distribution. In determining profits available for distribution

- any amount deemed to be a profit available for distribution under the definition of 'dividend' in s 1 must be included, and
- any prohibition or limitation on any distribution contained in the company's memorandum and articles of association or founding statement or any agreement must be disregarded.

The deemed dividend determined under s 64C(2)(e) (transfer pricing or thin capitalisation adjustments) applies regardless of whether there are any profits available for distribution.

¹²¹ The word 'remuneration' as defined in the Fourth Schedule applies for the purposes of that Schedule only unless otherwise stated.

In determining the profits and reserves available for distribution for the purposes of s 64C(2) read with s 64C(4)(c), the common law rules governing divisible profits must be taken into account (see 2.3). These rules were referred to in *CIR v Dirmeik*,¹²² a case dealing with the now repealed s 8B. Section 8B was a provision similar to s 64C(2)(g) that deemed certain loans to shareholders to be dividends in the hands of those shareholders.

For example, these rules state that a dividend can be declared out of the current year's profits without first making good past trading losses. Thus, if a company advances an interest-free or low-interest loan to its shareholder in a year in which it has made a profit, the loan will be regarded as a dividend to the extent of that profit, regardless of the fact that the company may have accumulated losses brought forward from previous years.

Another rule provides that it is not necessary to provide for depreciation on fixed assets when determining divisible profits. This rule must, however, not be applied indiscriminately as it must be read with the other rule that provides that the accounts as a whole must be fairly taken. In other words, one cannot simply add back depreciation without considering the fair values of all the company's assets. As a rule SARS will not add back depreciation when determining divisible profits when it has been provided for in accordance with GAAP and is not excessive.

Example – Determination of profits and reserves available for distribution

Facts:

A company advanced an interest-free loan of R100 to its shareholder during the current tax year when its balance sheet appeared as follows:

	R
Share capital	100
Profit – current year	100
Accumulated loss brought forward from previous year	(50)
	<u>150</u>
Loan	100
Cash	<u>50</u>
	<u>150</u>

Result:

As the company has R100 available for distribution in the current year, the loan of R100 will be regarded as a dividend for the purposes of s 64C(2)(g). Under the law governing divisible profits it is not necessary to first make good past trading losses.

4.4.5 Loans bearing interest at or above the official rate (s 64C(4)(d))

A loan to a shareholder or connected person in relation to a shareholder will not be deemed to be a dividend if the loan bears interest at not less than the official rate of interest as defined in para 1 of the Seventh Schedule to the Act. That definition reads as follows:

“[O]fficial rate of interest” means—

- (a) in the case of a loan which is denominated in the currency of the Republic, the rate of interest fixed by the Minister from time to time by notice in the *Gazette*; or

¹²² 1996 (2) SA 736 (C), 58 SATC 101.

- (b) in the case of a loan which is denominated in any other currency, a market related rate of interest’.

The official rate of interest with effect from 1 October 2010 is 7% (previously 8% from 1 September 2009). For an up-to-date table of official rates, see the SARS website (www.sars.gov.za) under Legal & Policy / Publications – Tables of Interest Rates.

This is an 'all or nothing' exclusion. Should a loan bear interest at less than the official rate it will not qualify for the exclusion, regardless of the interest rate being charged.

Under s 64C(6)(e) the dividend is deemed to be declared on the date on which the loan or advance is made available as contemplated in s 64C(2)(g). It follows that the decision as to whether the exemption applies must be made at the time the loan is granted. A deemed dividend will not be triggered in respect of a fixed-interest loan should the official rate later rise above the actual rate.

If a rate of interest below the official rate is subsequently negotiated, a new loan will come into existence through novation,¹²³ and this will trigger a deemed dividend at that point.

4.4.6 Loans to employees (s 64C(4)(e))

A loan to a shareholder or connected person in relation to a shareholder will not be deemed to be a dividend if

- the shareholder or connected person is an employee of the company, or
- the shareholder or connected person is an employee of an associated institution as defined in para 1 of the Seventh Schedule,

and

- the loan is granted under, and in compliance with the normal terms and conditions of, a loan scheme generally available to employees of the company or of the associated institution who are not shareholders.

The term ‘associated institution’ is defined in para 1 of the Seventh Schedule as follows:

“‘[A]ssociated institution”, in relation to any single employer, means—

- (a) where the employer is a company, any other company which is associated with the employer company by reason of the fact that both companies are managed or controlled directly or indirectly by substantially the same persons; or
- (b) where the employer is not a company, any company which is managed or controlled directly or indirectly by the employer or by any partnership of which the employer is a member; or
- (c) any fund established solely or mainly for providing benefits for employees or former employees of the employer or for employees or former employees of the employer and any company which is in terms of paragraph (a) or (b) an associated institution in relation to the employer, but excluding any fund established by a trade union or industrial council and any fund established for postgraduate research otherwise than out of moneys provided by the employer or by any associated institution in relation to the employer.’

¹²³ Under novation an existing obligation is replaced by a new one, the existing obligation being discharged. See R H Christie *Christie – Law of Contract in South Africa* 5 ed (2006) [CD-ROM] (*My LexisNexis*: 28 February 2006) LexisNexis Butterworths, Durban at 449.

4.4.7 Once-off concession in respect of loan repayments (s 64C(4)(f))

A loan or credit granted to a shareholder or connected person in relation to a shareholder will not be deemed to be a dividend if

- the loan or credit is repaid or otherwise extinguished by not later than the end of the company's year of assessment that succeeds the year of assessment in which the loan or credit was granted,
- the amount repaid/extinguished is not included in any subsequent loan or credit granted to the shareholder or any connected person in relation to the shareholder, and
- the concession has not been applied by the company in any previous year of assessment.

This exemption is a once-off concession. If the company has made use of it in a previous year of assessment it may not be used again. The intention of s 64C(4)(f)(ii) is that the amount repaid is not readvanced, say, as a new loan bearing interest at the official rate. There must be a causal link between the amount repaid and any further advance to the shareholder. For example, if an interest-free loan is repaid on day 1 and an identical amount bearing interest at the official rate is readvanced on day 2, it will be obvious that the exemption will not apply because there was never a genuine intention that the original loan be repaid. Generally, the longer the period between the repayment and any new loan, the less likely it will be that there will be a *nexus* between the repayment of the old loan and the readvance of the new one. The facts and circumstances of any new loan will have to be considered in determining whether there is a link between the repayment and the readvance.

The question arises as to when a loan will be a dividend, since until a company has used this provision, the STC liability depends on whether the loan will be repaid by the end of the succeeding tax year. The answer to this question is to be found in s 64C(6)(e) which deems the dividend to be declared on the date that

‘the loan or advance is made available as contemplated in subsection (2)(g)’.

It follows that the dividend arises when the loan is made, and not at the end of the succeeding year of assessment. Should a company decide that a loan will be repayable by the end of the succeeding year, and this turns out not to be the case, the company will be liable for interest on late payment of STC, calculated from the date on which the loan was made.

It often happens that shareholders withdraw large sums of money from their companies – especially upon cessation of operations, without being aware of the adverse STC consequences. It may only be later in the following financial year when the financial statements are being prepared that the STC consequences will be identified by the accountant or tax advisor. As a result, a company that is to be liquidated or deregistered may be denied the exemption under s 64B(5)(c) in respect of pre-1993 profits and pre-1 October 2001 capital profits because the loan may have been advanced more than 18 months before the lodging of the documents referred to in s 41(4). This concession provides an escape route for such companies.

Example – Once-off concession in respect of loans repaid by end of succeeding year*Facts:*

Mike is the sole shareholder of ABC (Pty) Ltd which has a February year end. The company's main asset was a block of flats from which it had derived rental income for the past 20 years. On 1 March 2008 the company disposed of the block of flats and immediately advanced the net proceeds to Mike. In September 2009, the company's auditors discovered what had transpired. The company's balance sheet appeared as follows:

<i>Capital employed</i>	R
Share capital	100
Capital profit on sale of flats	
- derived before 1 October 2001	750 000
- derived on or after 1 October 2001	250 000
Retained income	
– pre-1993	100 000
– post-1993	<u>200 000</u>
	<u>1 300 100</u>
 <i>Employment of capital</i>	
Loan to Mike	<u>1 300 100</u>

What are the STC implications for the company and what can Mike do to ensure that the pre-1993 revenue profits and pre-CGT capital profits can be withdrawn from the company free of STC? Assume that the company has not previously used s 64C(4)(f).

Result:

Under s 64C(2)(g) the company is liable to STC on a deemed dividend of R1 300 000, being the amount advanced to Mike, less the nominal share capital (s 64C(4)(c)).

Since the company has not taken the steps listed in s 41(4) to liquidate, wind up or deregister within 18 months, the exemption in s 64B(5)(c) will not be available unless the Commissioner extends the period. However, if Mike repays the loan by no later than 28 February 2010 the loan will no longer be deemed to be a dividend (s 64C(4)(f)). Thereafter, the necessary steps to liquidate or deregister the company within the prescribed period can be taken, and the s 64B(5)(c) exemption can be accessed.

4.4.8 Loan to employee share purchase trust (s 64C(4)(i))

A loan or credit granted by a company to a trust will not be deemed to be a dividend when

- the loan is made to the trust for the purpose of enabling it to purchase shares in the company or its controlling company, and
- the shares must be acquired by the trust with a view to resale to employees of the company, under a share incentive scheme operated by the company for the benefit of its employees.

4.4.9 Certain deemed dividends to shareholder forming part of same group of companies (s 64C(4)(k))

An amount that is distributed, transferred, released, relieved, paid, settled, used, applied, granted or made available for the benefit of any shareholder or connected person in relation

to a shareholder will not be deemed to be a dividend if it arose under the following paragraphs of s 64C(2) and complies with the requirements below:

Table 1 – Deemed dividends potentially qualifying for exemption under s 64C(4)(k)

Section 64C(2)	Description
(a)	Transfer of cash or assets
(b)	Release from obligation
(c)	Settlement of third party debt
(d)	Amounts applied or used for the shareholder's benefit
(g)	Loan or advance

Excluded from the ambit of the exemption are amounts deemed to be dividends under the following provisions:

Table 2 – Deemed dividends not qualifying for exemption under s 64C(4)(k)

Section 64C(2)	Description	Reason excluded
(e)	Transfer pricing / thin capitalisation adjustments	The <i>fiscus</i> does not allow the understatement of taxable income through transfer pricing within a multi-national group of companies.
(f)	Cessation of residence	Once residence ceases the company falls outside SA's taxing jurisdiction.
(h)	Hybrid debt instruments	The <i>fiscus</i> does not condone the understatement of taxable income through the disguise of dividends as interest payments.

Under s 64C(4)(k)(i), in order to qualify for the exemption, the shareholder must be part of the same 'group of companies' as defined in s 41 as the company that is deemed to have declared the dividend. See the definition of that term in s 64B(1) which refers to the s 41 definition. Thus deemed dividends declared to non-resident companies and certain tax-exempt or partially tax-exempt companies fall outside the ambit of a group of companies for this purpose.

Example 1 – Loan to non-resident holding company

Facts:

Holdco is a non-resident company that owns 100% of Subco, a company that is resident in South Africa. Subco lends R100 to Holdco at a time when Subco has reserves of R200 available for distribution.

Result:

Under s 64C(2)(g) Subco is deemed to have declared a dividend of R100 and will pay STC thereon of R10. The exemption in s 64C(4)(k) does not apply to Subco because Holdco does not form part of the same 'group of companies' as defined in s 41 as Subco.

Under s 64C(4)(k)(ii) the exemption also applies to a connected person in relation to a shareholder if the connected person and the shareholder form part of the same group of companies as the company that is deemed to have declared the dividend. Section 64C(4)(k) thus covers both upward (to a shareholder), downward (to a subsidiary) and sideways (to a fellow subsidiary) distributions.

If the profits of the distributing company are reduced by the deemed dividend, this exemption only applies to the extent that the profits of the recipient company are correspondingly increased (proviso to s 64C(4)(k)).

Example 2 – Exemption of deemed intra-group dividends

Facts:

Company H holds all the shares of Company S1, and 70% of the shares in Company S2. Company S2 is indebted to Company S1 for R100. Company S1 cancels the debt. All three companies are residents and are not tax-exempt entities.

Result:

Under s 64C(2)(b), cancellation of the debt due by Company S2 to Company S1 is a deemed dividend of R100 by Company S1 to Company H.

This deemed dividend is, however, exempt from STC under s 64C(4)(k)(ii) since S1 and S2 are part of the same 'group of companies' as defined in s 41. In addition the requirements of the proviso to s 64C(4)(k) are met because the profits of Company S2 would increase by the amount of the waiver of the debt, while the profits of Company S1 will decrease by a like amount.

4.4.10 Certain deemed dividends for the benefit of controlled group company (s 64C(4)(l))

This exemption applies to the types of deemed dividends set out in the table below.

Table 1 – Deemed dividends potentially qualifying for exemption under s 64C(4)(l)

Section 64C(2)	Description
(a)	Transfer of cash or assets
(b)	Release from obligation
(c)	Settlement of third party debt
(d)	Amounts applied or used for the shareholder's benefit
(g)	Loan or advance

The exemption does not apply to the following types of deemed dividends:

Table 2 – Deemed dividends not qualifying for exemption under s 64C(4)(l)

Section 64C(2)	Description	Reason excluded
(e)	Transfer pricing and thin capitalisation adjustments	The <i>fiscus</i> does not allow the understatement of taxable income through transfer pricing within a multi-national group of companies.
(f)	Cessation of residence	Once residence ceases the company falls outside SA's taxing jurisdiction.
(h)	Hybrid debt instruments	The <i>fiscus</i> does not condone the understatement of taxable income through the disguise of dividends as interest payments.

The exemption under s 64C(4)(l) applies when

- the company declaring the deemed dividend alone or together with any other company forming part of the same s 41 group of companies as that company directly or indirectly

holds at least 20% of the total equity share capital of the company receiving the dividend; and

- the recipient company does not hold any equity shares in the company, or in any company forming part of the same group of companies as defined in s 41 as the declaring company.

This exemption is aimed at exempting downward and sideways distributions. As a commercial matter, loans or advances by a holding company to a subsidiary should not be viewed as a deemed dividend. The holding company is not denuded of value; the value is simply moved from direct to indirect control. This movement is more akin to a capital contribution.

The recipient need not form part of the more narrowly defined s 41 'group of companies'. Thus there is no requirement that the recipient be a resident, nor that the declaring company hold at least 70% of the equity shares in the recipient company.

Example 1 – Downward distribution to non-resident subsidiary

Facts:

Holding Company, a resident, owns all the shares of Subsidiary, a non-resident. Subsidiary does not directly or indirectly own shares in Holding Company. Holding Company makes an interest-free loan to Subsidiary.

Result:

Despite the favourable terms of the loan, it does not give rise to a deemed dividend because it falls within s 64C(4)(l). In this regard, Holdco owns at least 20% of Subsidiary while Subsidiary holds no shares in Holdco whether directly or indirectly. The downward deemed dividend is thus exempt from STC.

Example 2 – Sideways distribution to non-resident fellow subsidiary

Facts:

Holding Company, a resident, owns all the shares of Subsidiary 1, a resident, and Subsidiary 2, a non-resident. Neither subsidiary directly or indirectly owns any shares in Holding Company. Subsidiary 1 makes an interest-free loan to Subsidiary 2.

Result:

Despite the favourable terms of the loan, it does not give rise to a deemed dividend because it falls within s 64C(4)(l). Holdco and Subsidiary 1 are part of the same group of companies as defined in s 41. Since Holdco owns at least 20% of Subsidiary's shares and Subsidiary 2 owns no shares in Holdco or Subsidiary 1, the loan by Subsidiary 1 is exempt from STC.

4.5 Repayment of loans deemed to be incoming dividends (s 64C(5))

When any loan granted by a company to a shareholder or any connected person in relation to the shareholder

- was deemed to be a dividend declared by the company under s 64C, and
- is thereafter wholly or partly repaid by the shareholder or connected person,

the amount so repaid is for the purposes of s 64B deemed to be a dividend which accrued to the company concerned on the date on which that amount was repaid. In other words, the amount will comprise a deemed incoming dividend.

In the case of a debt repayable in instalments, each instalment is a dividend accruing on the date of each repayment.

The mechanism provided for in s 64C(5) to some extent addresses the double taxation of the same reserves when an actual dividend is declared in a year subsequent to the year in which an amount is deemed to be a dividend.

Example – Repayment of loan deemed to be an incoming dividend

Facts:

In year 1 ABC (Pty) Ltd made an interest-free loan of R100 to Heather, the sole shareholder of the company, when the company had reserves of R110 available for distribution. In year 3 Heather repaid the loan to the company, which immediately declared a dividend of R100 to Heather.

Result:

In year 1 the company will be liable to STC of R10 on the deemed dividend of R100 under s 64C(2)(g). In year 3 the company's net amount will be determined as follows:

	R
Deemed incoming dividend	100
Less: Dividend declared	<u>(100)</u>
Net amount	<u>Nil</u>

4.6 Time of declaration in respect of deemed dividend (s 64C(6))

The table below sets out the dates of declaration of deemed dividends. These dates are required for the purpose of determining the end of the dividend cycle.

Table 1 – Deemed dates of declaration in respect of deemed dividends

Type of deemed dividend under s 64C(2)	Section 64C(6)	Date of declaration under s 64C(6)
(a)	(a)	Upon distribution or transfer of cash or assets.
(b)	(b)	When the obligation is released or relieved.
(c)	(c)	When the debt is paid or settled.
(d)	(d)	When the amount is used or applied.
(g)	(e)	When the loan or advance is made available.
(h)	(f)	When the amount is incurred.

Chapter 5 – STC and the corporate restructuring rules (ss 41 – 47)

5.1 Introduction

The corporate restructuring rules in ss 41 to 47 provide mainly income tax and CGT relief. However, two of the rules, namely, those relating to amalgamation and unbundling transactions contain specific STC measures. The table below summarises the impact of the corporate restructuring rules on STC.

Table 1 – The corporate restructuring rules and STC

Section	Description	Contains provisions affecting STC?
41	General	Yes – s 41(4). Contains the steps that need to be taken within 18 months (or such further period as the Commissioner may allow) of declaring a dividend for the purposes of s 64B(5)(c). These steps must also be satisfied for the purposes of ss 44(13) and 47(6)(c).
42	Asset-for-share transactions	No.
44	Amalgamation transactions	Yes – s 44(9), (9A), (10) and (13)
45	Intra-group transactions	No
46	Unbundling transactions	Yes – s 46(5) and (6)
47	Transactions relating to liquidation, winding-up and deregistration	Yes, s 47(6)(c)(i) stipulates the period within which a company must be liquidated or deregistered for the purposes of s 64B(5)(c).

5.2 Indirect STC consequences of non-arm's length transactions

The corporate rules do not regulate the prices at which assets are disposed of for accounting purposes. This can have an impact on the reserves of transferor and transferee companies that will impact on the future STC liability of those companies. There can also be indirect or unexpected STC consequences from intra-group transactions involving pre-1 October 2001 assets, as illustrated in the example below.

Example – Impact on STC liability of intra-group transactions

Facts:

For accounting purposes Company A transfers a pre-valuation date asset to Company B at cost price. The details of the asset are as follows:

	R
Cost	100
Market value on 1 October 2001	250
Market value at date of transfer	300

Company B later sold the asset to an unconnected person for R350.

Result:

Company A will show no gain / no loss for accounting purposes. For STC purposes Company B is regarded as having acquired the asset for R100 on the date of the transaction (that is, post-1 October 2001) in contrast to the CGT roll-over rules. When Company B sells the asset it will have a post-valuation date capital profit of R350 – R100 = R250, which will be fully subject to STC when Company B is liquidated or deregistered. Had Company A transferred the asset to Company B at its market value of R300

- Company A's books would reflect a pre-valuation date capital profit of R150 (R250 – R100) and a post-valuation date capital profit of R50 (R300 – R250), and
- Company B's books would reflect a post-valuation date capital profit of R50 (R350 – R300).

In other words, by transferring the asset at market value, Company A has kept the pre-1 October 2001 capital profit intact, and will be able to extract it STC free on liquidation or deregistration under s 64B(5)(c).

5.3 Interaction with s 64B

Some of the corporate restructuring rules must be read in conjunction with the existing relief measures contained in s 64B. For example, in a s 47 liquidation transaction, a subsidiary will transfer its assets to its holding company free of CGT and income tax. There are, however, no specific STC relief measures in s 47 for such a transaction. But the subsidiary can make use of s 64B(5)(c) or (f) or a combination of the two exemption provisions.

5.4 Amalgamation transactions (s 44(9), (9A) and (10))

An 'amalgamation transaction' occurs when

- one company (the amalgamated company – 'A') disposes of all its assets to another company (the resultant company – 'B') in exchange for shares in B,
- A then distributes the B shares to its shareholders, and
- A is thereafter liquidated or deregistered.

STC consequences can arise when A distributes the B shares to its shareholders as a dividend.

Section 44(9)

Section 44(9) provides that in determining the net amount for STC purposes

- A must not treat the distribution of the B shares as an outgoing dividend, and
- any corporate shareholder of A is not permitted to treat the receipt of the B shares as an allowable incoming dividend.

Section 44(9A)

Section 44(9A) provides that when s 44(9) applies

- the resultant company's equity share capital (including any share premium) arising from the amalgamation transaction must be deemed to be a profit not of a capital nature available for distribution to its shareholders for the purposes of para (i) of the first proviso

to the definition of 'dividend' to the extent of any profits distributed by the amalgamated company under s 44(9), and

- those deemed profits must be deemed to have arisen immediately before the date on which the resultant company became part of any group of companies.

The purpose of the first bullet point is to 'taint' the resultant company's share capital and share premium *to the extent* of any profits that are distributed STC free by the amalgamated company. Should the resultant company effect a subsequent reduction in share capital or share premium, including buying back its own shares, it will be deemed to have distributed a dividend. The effect of s 44(9A) is therefore to ensure that any profits exempted from STC in the hands of the amalgamated company remain within the STC net. The words 'to the extent' ensure that the tainting of the resultant company's share capital and share premium is limited to the amount of the profits of the amalgamated company that enjoyed exemption from STC. The deemed profits of the resultant company are also deemed to be not of a capital nature. This prevents the resultant company from claiming any exemption under s 64B(5)(c) in the event of it being liquidated or deregistered.

The second bullet point deems the deemed profits in the resultant company to have arisen before it became part of any group of companies. The purpose of this provision at the time it was enacted was to ensure that the resultant company cannot escape STC by making an election under s 64B(5)(f). At the time the second proviso to s 64B(5)(f) prevented an election for a dividend distributed out of pre-group profits, but this requirement has since been deleted.

Example – Section 44(9A)

Facts:

Resident Company A's balance sheet appears as follows:

	R
Share capital	100
Retained income	<u>100 000</u>
	<u>100 100</u>
Assets	<u>100 100</u>

All Company A's shares are held by Foreign Holdco, a non-resident company based in the Cayman Islands.

Holdco initiates the formation of Newco, a resident company, which issues 100 shares of R1 each to Company A at a premium of R100 000 in exchange for Company A's assets. Company A then distributes the Newco shares to Foreign Holdco free of STC under s 44(9) after which Company A is liquidated. On or after 21 February 2007 Newco repays the share premium of R100 000.

Result:

Under s 44(9A) Newco will be deemed to have distributed a dividend of R100 000 when it repays its share premium account. Newco is not permitted to make a s 64B(5)(f) election in respect of the deemed dividend because Foreign Holdco is not subject to STC.

Effective date

Under s 32(2) of the Taxation Laws Amendment Act 8 of 2007 s 44(9A) is deemed to have come into operation on 21 February 2007 and applies to any reduction or redemption of the

share capital or share premium of a resultant company, including the acquisition by that company of its shares under s 85 of the Companies Act on or after that date. The provision therefore also applies to amalgamation transactions entered into before 21 February 2007 when the resultant company effects a share capital reduction or share buy-back on or after that date. It is therefore only share capital or share premium reductions or share buy-backs which occurred before 21 February 2007 that will fall outside s 44(9A).

Section 44(10)

Section 44(10) deals with the situation in which the amalgamated company distributes cash or assets in addition to the shares in the resultant company to its shareholders as part of an amalgamation transaction. In such event, that cash or asset portion of the distribution is deemed to be

- an outgoing dividend subject to STC in the hands of the amalgamated company, and
- an incoming dividend in the hands of a corporate shareholder.

The amount of the dividend is limited to the reserves of the amalgamated company that are available for distribution as contemplated in s 64C(4)(c). Under that section, the amounts available for distribution include

- amounts treated as being available for distribution under the definition of 'dividend' in s 1 (for example, capitalised reserves), and
- any amounts which may not be distributable by reason of a prohibition or limitation in the company's memorandum or articles of association or founding statement, or under any agreement.

The incoming dividend is deemed to accrue to the shareholder on the date on which that shareholder became entitled to it.

5.5 Unbundling transactions (s 46(5), (6) and (7))

An 'unbundling transaction' occurs when one company (the unbundling company – 'B') distributes all its shares in a resident company or CFC (the unbundled company – 'C') to its shareholders ('A') as a distribution *in specie*.

B must

- be resident if listed,
- distribute the C shares to qualifying A shareholders, and
- hold a minimum % of shares in C.

The relief (including STC relief described below) does not apply to the extent C shares are distributed to non-qualifying A shareholders (see s 46(7)(b)).

Section 46(5) provides that for the purposes of determining the net amount

- the distribution of unbundled company shares is deemed not to be an outgoing dividend in the hands of the unbundling company (that is, it is exempt from STC), and
- when the recipient of those shares is a company, the receipt of the shares is deemed not to be an allowable incoming dividend.

It follows that when the shareholder is a qualifying company, s 46(5) acts as a deferral measure, since any STC would remain potentially payable when the recipient on-declares the

profits represented by the dividend. But when the recipient is an individual or trust as in the case of a listed unbundling company, the *fiscus* permanently forfeits any right to recover STC on the reserves distributed to such shareholders.

Non-qualifying companies

Section 46(7)(a) denies the STC relief to B if, immediately after any distribution of shares under an unbundling transaction, 20% or more of the shares in B are held by a disqualified person either alone or together with any connected person (who is a disqualified person) in relation to that disqualified person. The term 'disqualified person' is defined in s 46(7)(b) and means

- a person that is not a resident;
- the Government, a provincial administration or municipality;
- an approved PBO;
- an approved recreational club; and
- a number of other specified entities.

In determining whether the 20% threshold has been breached, the holdings of connected persons must be taken into account. This was designed, for example, to prevent a foreign holding company from bypassing the rule by splitting its 20%+ holding among several foreign subsidiaries.

Section 46(6) provides that any shares distributed are deemed to first come out of the share premium account of the unbundling company. Should an unbundling company have adopted the cost model for accounting for its investment in the unbundled company, it is accepted that the share premium account need only be reduced by the carrying value of the investment, and not by its market value. In this regard s 46(6) refers to 'shares distributed . . . from the share premium account', and does not use the word 'amount' as is the case in the definition of 'dividend' (see **2.2**).

Annexure A – Main legislative provisions affecting STC

[As amended by Taxation Laws Amendment Act 17 of 2009]

A1. Definition of ‘dividend’ (s 1 of the Income Tax Act 58 of 1962)

“**dividend**” means any amount distributed by a company (not being an institution to which section 10(1)(d) applies) to its shareholders, and in this definition the expression “**amount distributed**” includes—

- (a) in relation to a company that is being wound up, liquidated or deregistered or the corporate existence of which is finally terminated, any profits distributed in the course of the winding up, liquidation, deregistration or final termination of that company: Provided that any profits distributed by the liquidator of the company are deemed for purposes of this definition to have been distributed by the company;
- (b) in relation to a company that is not being wound up, liquidated, or deregistered or where the corporate existence of that company is not finally terminated, any profits distributed, including an amount equal to the nominal value, at the time of issue thereof, of any capitalisation shares awarded to shareholders and the nominal value of any bonus debentures or securities awarded to shareholders;
- (c) any reduction of the profits of a company as a result of—
 - (i) the reduction of the capital of that company; or
 - (ii) the acquisition, cancellation or redemption of shares issued by that company; and
- (cA)
- (cB) any reduction of the profits of a company, if—
 - (i) that company holds shares in any other company which is a shareholder in relation to that company; and
 - (ii) those shares are cancelled,
- (d)

but does not include—

- (e) the nominal value of any capitalization shares awarded to a shareholder to the extent to which such shares have been paid up by means of the application of the whole or any portion of the share premium account of a company;
- (f) subject to the provisions of the first proviso to this definition, any distribution to the extent that it represents a reduction of the share capital or share premium account of a company;
- (g) any amount distributed by a company to a shareholder where the company and the shareholder form part of the same group of companies as defined in section 41, to the extent that the shareholder reduces the cost of the shares held in the company in accordance with generally accepted accounting practice as a result of the distribution;
- (h) the nominal value of any capitalization shares awarded to shareholders as part of the equity share capital of a company;
- (i) any amount distributed by a co-operative by way of a bonus, to the extent that such amount is allowable as a deduction from the income of such co-operative under the provisions of section 27;

- (j) any amount distributed by way of the redemption of a participatory interest in a portfolio, arrangement or scheme contemplated in paragraph (e) of the definition of “company”:

Provided that, for the purposes of this definition—

- (i) where a company has on or after 1 January 1974 transferred any amount from reserves (excluding any share premium account) or undistributed profits to the share capital or the share premium account of the company without applying the amount in paying up capitalization shares or has applied the amount in paying up capitalization shares the nominal value of which did not in whole or in part constitute an amount distributed as contemplated in the foregoing provisions of this definition, the amount so transferred (reduced by so much thereof as constitutes such an amount distributed) shall be deemed—
- (aa) to the extent that such amount (as so reduced) is shown to consist of profits of a capital nature, to be a profit of a capital nature available for distribution by the company to shareholders who, in the event of a distribution by the company at any time (whether before or during the winding-up or liquidation of the company) of profits of a capital nature would be entitled to participate in such a distribution; and
- (bb) to the extent that subparagraph (aa) does not apply, to be a profit which is not of a capital nature and is available for distribution by the company to shareholders who, in the event of a distribution by the company at any time (whether before or during the winding-up or liquidation of the company) of profits which are not of a capital nature would be entitled to participate in such a distribution,
- regardless of whether in either case the company in fact has or has not any profits available for distribution;
- (ii) where the share capital of the company consists of different classes of share capital, any amount deemed by paragraph (i) of this proviso to be available for distribution to shareholders shall, in applying that paragraph, be apportioned between such classes of share capital in accordance with the rights of the holders of the corresponding classes of shares to participate in distributions of profits of a capital nature or profits which are not of a capital nature, as the case may be, and the amount deemed by the said paragraph to be available for distribution to the shareholders in respect of any such class of shares shall be the amount allocated to the share capital of that class under such apportionment;
- (iiA) where any amount is under the provisions of paragraph (i) of this proviso or that paragraph as applied by paragraph (ii) of this proviso, deemed to be a profit available for distribution to shareholders and any of the shares of any class (hereinafter referred to as the original shares) held by any such shareholders are converted into shares of any other class or the original shares are cancelled and shares of any other class are issued in place of the original shares, the said amount shall, to the extent that it relates to or may have been apportioned to the original shares, be deemed to relate to and to be a profit available for distribution to the shareholders in respect of the shares of such other class and the provisions of this proviso shall, to the extent that the said amount is deemed to consist of a profit as aforesaid, apply in respect of such amount as though it were an amount referred to in paragraph (i) of this proviso, and the shareholders in respect of the shares of such other class shall, regardless of the rights attaching to such shares, be deemed as respects the said amount to be entitled to participate in profits of the same

nature as the profit deemed by this paragraph to be available for distribution to the shareholders, whether such profit is of a capital nature or is not of a capital nature;

- (iiB) subject to the provisions of paragraphs (iiA) and (iv) of this proviso, where any amount is under the provisions of paragraph (i) of this proviso or that paragraph as applied by paragraph (ii) of this proviso, deemed to be a profit available for distribution to shareholders and any shares issued by the company are cancelled without a return of the share capital or any share premium relating to such shares, such share capital or share premium or any reserve created by reason of the cancellation of such shares shall, to the extent that the said profit may be apportioned to the said shares, be deemed to consist of a profit (of the same nature as the aforesaid profit) available for distribution to shareholders who are or may become interested in such share capital, share premium or reserve, and where any cash is or any assets are given to shareholders by way of a return of or a distribution out of such share capital, share premium or reserve, the sum of the amount of such cash and the value of such assets shall, to the extent that such sum does not exceed the amount deemed by this paragraph to consist of a profit available for distribution to shareholders, be deemed to be a profit (of the same nature as the first-mentioned profit) distributed to the shareholders;
- (iii) if, in the event of any partial reduction of the capital of a company or acquisition, cancellation or redemption of shares issued by that company, any cash or any asset is given to a shareholder and the cash or asset (or a portion thereof) represents a return of share capital or share premium, the amount of share capital or share premium so returned—
 - (aa) to shareholders entitled to participate in distributions of profits which are not of a capital nature and in respect of whom any amount is deemed under paragraph (i) (bb) of this proviso to be such a profit available for distribution to such shareholders, shall (to the extent that the amount returned to such shareholders does not exceed the aggregate of the amounts of the profits so deemed to be available for distribution to such shareholders) be deemed to be a profit, not of a capital nature, distributed to such shareholders, and the amounts so deemed to be available for distribution shall be deemed to have been reduced accordingly; or
 - (bb) to shareholders entitled to participate in distributions of profits of a capital nature and in respect of whom any amount is deemed under paragraph (i)(aa) of this proviso to be such a profit available for distribution to such shareholders, shall (to the extent that the amount returned to such shareholders (less so much thereof as is deemed under subparagraph (aa) of this paragraph to be a profit, not of a capital nature, distributed to such shareholders) does not exceed the aggregate of the amounts of the profits deemed under the said paragraph (i)(aa) to be available for distribution to such shareholders) be deemed to be a profit of a capital nature distributed to such shareholders and the amounts so available for distribution shall be deemed to have been reduced accordingly;
- (iiiA) in the event of the reduction of the share capital or share premium of a company, or the acquisition, cancellation or redemption of shares issued by that company, in relation to a class of shareholders, that company must be deemed to have distributed profits to the shareholders in that class to the

extent that the share capital and share premium so reduced exceeds the share capital and share premium contributed by that class of shareholders;

- (iv) where the company has lost some of its paid-up share capital (including any share premium) as a result of losses actually incurred by it and such share capital is in consequence partially reduced to take account of such losses, any amounts which in terms of this proviso are at the date of such partial reduction of such share capital deemed to be profits available for distribution to shareholders shall be deemed to have been reduced to the extent that such losses are so accounted for and in such manner that, as far as possible and on the basis, where necessary, of an apportionment between different classes of share capital in accordance with the rights of shareholders—
 - (aa) any such profits which are of a capital nature and relate to shareholders entitled to participate in profits of that nature, are reduced by so much of the amount by which the said share capital is reduced as is attributable to losses of a capital nature; and
 - (bb) any such profits which are not of a capital nature and relate to shareholders entitled to participate in profits which are not of a capital nature, are reduced by so much of the amount by which the said share capital is reduced as is attributable to losses which are not of a capital nature;
- (v) in the event of the winding-up or liquidation of the company—
 - (aa) any profits which in terms of the preceding provisions of this proviso are, at the commencement of the winding-up or liquidation, deemed to be available for distribution to shareholders shall, if the company has lost some of its paid-up share capital (including any share premium) as a result of losses actually incurred by it, be deemed to have been reduced in such manner that, as far as possible and on the basis, where necessary, of an apportionment between different classes of share capital in accordance with the rights of shareholders—
 - (A) any such profits which are of a capital nature and relate to shareholders entitled to participate in profits of that nature, are reduced by so much of the loss of the said share capital as is attributable to losses of a capital nature; and
 - (B) any such profits which are not of a capital nature and relate to shareholders entitled to participate in profits which are not of a capital nature, are reduced by so much of the loss of the said share capital as is attributable to losses which are not of a capital nature; and
 - (bb) the aggregate of any cash and the value of any assets given to shareholders entitled to participate in profits not of a capital nature shall, to the extent that such aggregate exceeds so much of the sum of the share capital and any share premium contributed by such shareholders (less so much of such share capital and share premium as has been lost) as remains after deducting therefrom an amount equal to so much of any profits, not of a capital nature, which are deemed by this proviso (after applying subparagraph (aa) of this paragraph) to be available for distribution to such shareholders at the commencement of the winding-up or liquidation, as relates to the said share capital, be deemed to be a profit, not of a capital nature, distributed to such shareholders, but the

amount of that profit shall not be determined at an amount which exceeds the aforesaid amount:

Provided further that a reserve of any company which consists of or includes any amount transferred from the share premium account of the company shall, except to the extent to which such reserve consists of any other amount, be deemed for the purposes of this definition to be a share premium account of, or share premium received by, such company: Provided further that for the purposes of this definition “**profits**” includes realised and unrealised profits of a company whether or not those unrealised profits have been recognised in the financial records of the company;

Sections 64B and 64C of Income Tax Act 58 of 1962

A2. Section 64B

64B. Levy and recovery of secondary tax on companies.—(1) For the purposes of this Part—

“affected company”

“declared”, in relation to any dividend (including a dividend *in specie*), means the approval of the payment or distribution thereof by the directors of the company or by some other person under authority conferred by the memorandum and articles of association of the company or, in the case of the liquidation of a company, by the liquidator thereof;

“dividend cycle” means—

- (a) in relation to the first dividend declared by a company (other than a company which carries on long-term insurance business) on or after 17 March 1993, the period commencing on the later of—
 - (i) 1 September 1992;
 - (ii) the day following the date of declaration of the last dividend (other than a dividend *in specie* or a dividend payable on a preference share) declared by the company prior to 17 March 1993;
 - (iii) the date on which that company was incorporated, formed or otherwise established; and
 - (iv) the date on which that company becomes a resident,
 and ending on the date on which such first dividend accrues to the shareholder concerned or on which the amount is deemed to have been declared as contemplated in section 64C(6);
- (aA) in relation to the first dividend declared by a company which carries on long-term insurance business out of profits derived during any year of assessment commencing on or after 1 July 1993, the period commencing on the later of—
 - (i) the later date of the date on which that company was incorporated, formed or otherwise established or 1 July 1993; and
 - (ii) the day following the date of declaration of the last dividend (other than a dividend *in specie* or a dividend payable on a preference share) declared by the company prior to the declaration of the said first dividend,
 and ending on the date on which such first dividend accrues to the shareholder concerned or on which the amount is deemed to have been distributed as contemplated in section 64C(6); and
- (b) in relation to any subsequent dividend declared by that company, the period commencing immediately after the previous dividend cycle of the company and ending on the date on which such dividend accrues to the shareholder concerned or on which the amount is deemed to have been distributed as contemplated in section 64C(6);

“group of companies” means “group of companies” as defined in section 41; and

“holding company”

“intermediate company”

“**profit**” includes any amount deemed in terms of the definition of “dividend” in section 1 to be a profit available for distribution.

“**share incentive scheme**”

(2) There shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the secondary tax on companies, which is calculated at the rate of 10 per cent of the net amount, as determined in terms of subsection (3), of any dividend declared by any company which is a resident.

(3) Subject to subsection (3A), the net amount of any dividend referred to in subsection (2) is the amount by which the dividend declared by a company exceeds the sum of any dividends (other than any dividends contemplated in subsection (5)(c)) which have accrued to that company during the dividend cycle in relation to that first-mentioned dividend: Provided that—

- (a) where the sum of such dividends accrued exceeds such dividend declared, the excess shall be carried forward and be deemed to be a dividend which accrued to the company during the succeeding dividend cycle of the company; and
- (b) in the determination of the net amount of any dividend distributed in the course or in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of a company, there shall be allowed as a deduction any dividend contemplated in subsection (5)(c)(i) or (ii) which has during the current or any previous dividend cycle accrued to the company.

(3A) In determining the sum of the dividends which have accrued to a company as contemplated in subsection (3), no regard must be had to—

- (a) any dividend contemplated in subsection (5)(b) or (f);
- (b)
- (c) any dividend which accrued to a borrower as contemplated in the definition of “securities lending arrangement” in respect of a share which was borrowed in terms of that arrangement; or
- (d) any foreign dividend, other than a foreign dividend which accrued to that company (hereinafter referred to as the “recipient company”)—
 - (i) in circumstances other than as contemplated in subparagraph (ii) to the extent that the profits from which the dividend is distributed relate to an amount which has been subject to tax in the Republic in terms of this Act without reduction as a result of the application of any agreement for the avoidance of double taxation, at the rate applicable to a company which either—
 - (aa) mines for gold on any gold mine and which is in terms of an option exercised by it exempt from the payment of secondary tax on companies; or
 - (bb) has its place of residence outside the Republic and carries on a trade through a branch or agency within the Republic; or
 - (ii) to the extent that that foreign dividend arose directly or indirectly from any dividend declared by a company which is a resident (hereinafter referred to as the “resident company”) and which was subject to secondary tax on companies.

(4)(a) Where any dividend is declared by a company subject to the condition that it will be payable to shareholders registered in the company’s share register on a specified

date, such dividend or interim dividend shall for the purposes of this section be deemed to accrue to the shareholders on that date.

(b) Any interim dividend declared by a company otherwise than as contemplated in paragraph (a), shall for the purposes of this section be deemed to accrue to the shareholders on the date upon which it is declared.

(c) Where any cash or assets is or are transferred or distributed—

- (i) by a company to shareholders of that company otherwise than by way of a formal declaration of a dividend; or
- (ii) by the liquidator of a company to the shareholders of that company in the course of the winding up or liquidation of that company,

and the amount of such cash or the value of such assets, in whole or in part constitutes a dividend, such dividend shall for the purposes of this section be deemed to have been declared by the company and to have accrued to the shareholders on the date on which the shareholders became entitled to such cash or assets.

(5) There shall be exempt from the secondary tax on companies—

- (a) dividends declared by any company (other than a company that is a registered micro business as defined in the Sixth Schedule) the entire receipts and accruals of which, or so much of the receipts and accruals of which as are derived otherwise than from investments, are exempt from tax under the provisions of section 10: Provided that the provisions of this paragraph shall not apply to a company which is exempt from tax under the said provisions solely because it derives gross income of a particular nature;
- (b) any dividend declared by a fixed property company contemplated in section 11(s) which may be allowed as a deduction in the determination of the taxable income of such company in terms of the provisions of that section;
- (c) so much of any dividend declared in the course or in anticipation of the liquidation, winding up, deregistration or final termination of the corporate existence of a company, as is shown by the company to be a—
 - (i) distribution of profits derived during any year of assessment which ended not later than 31 March 1993, (other than any such profits derived by way of the revaluation of trading stock held by such company); or
 - (ii) distribution of profits of a capital nature (other than capital profits attributable to the disposal of any asset on or after 1 October 2001 which capital profits must, in the case of an asset acquired before that date, be limited to the amount of profit determined as if that asset had been acquired on 1 October 2001 for a cost equal to the market value of that asset on that date determined in the manner contemplated in paragraph 29 of the Eighth Schedule); or
 - (iii) distribution of realised or unrealised profits derived by that company before that company became a resident:

Provided that where such dividend is distributed in anticipation of the liquidation or winding up or deregistration of a company and such company—

- (i) has not within the period referred to in section 47(6)(c)(i) taken such steps as contemplated in section 41(4) to liquidate, wind up or deregister that company; or
- (ii) has at any stage withdrawn any step taken to liquidate, wind up or deregister that company, as contemplated in paragraph (i), or does

anything to invalidate any such step so taken, with the result that the company is or will not be liquidated, wound up or deregistered,

the provisions of this paragraph and of subsection (3)(b) shall be deemed not to have applied to such dividend and any secondary tax on companies which becomes payable as a result thereof shall be recoverable from the shareholders to whom such dividend was distributed in the same proportion as such dividend was so distributed;

- (d)
- (e) so much of any dividend declared by a company referred to in subsection (12)(e) during any subsequent year of assessment as contemplated in that subsection, as represents a distribution of an amount received by or accrued to such company as a result of the disposal of gold mining assets;
- (f) any dividend declared by a controlled group company as contemplated in the definition of “group of companies” which accrues to a shareholder (as defined in Part III) of that company if—
- (i) that shareholder is a company forming part of the same group of companies as the company declaring the dividend and that dividend is taken into account in the determination of the profits of that shareholder;
 - (ii)
 - (iii) that shareholder would be subject to secondary tax on companies should that shareholder—
 - (aa) declare a dividend from that dividend so declared by that company; and
 - (bb) not elect that this paragraph must apply in respect of that dividend; and
 - (iv)
 - (v) the company declaring the dividend elects the exemption under this paragraph to apply by submitting this election—
 - (aa) no later than the last day on which the secondary tax on companies would otherwise be due but for this paragraph (or no later than any other subsequent date prescribed by the Commissioner), and
 - (bb) in such form as the Commissioner may prescribe:

Provided that this exemption shall not apply to the extent to which that dividend consists of any shares in that shareholder: Provided further that the provisions of this paragraph do not apply in respect of a dividend declared by a controlling group company to a controlled group company in relation to that controlling group company;
- (g)
- (h)
- (i) in the case of any company which is a “qualifying company” as defined in section 37H, any dividend declared by such company during the period ending six months after the end of the last year of assessment during which such company qualifies for the tax holiday status referred to in that section out of profits derived during the period during which such company qualifies for such tax holiday status; and

(j)

(k) any dividend declared to a natural person which constitutes a transfer of an interest in a residence contemplated in paragraph 51 of the Eighth Schedule; and

(l) any dividend declared by any company that is a registered micro business as defined in the Sixth Schedule during any year of assessment during which such company is a registered micro business, to the extent that such dividend does not exceed the amount of R200 000 during such year.

(6)

(7) The secondary tax on companies shall be paid to the Commissioner by the company liable therefore by not later than the last day of the month following the month in which the dividend cycle relevant to such dividend ends and each payment of such tax shall be accompanied by a return in such form as the Commissioner may require: Provided that—

(i) the Commissioner may in any case extend the applicable date of payment; and

(ii) for the purposes of this subsection the expression “**month**” means any of the twelve portions into which any calendar year is divided.

(8) Where the Commissioner is satisfied that any amount of secondary tax on companies has not been paid in full, he may estimate the unpaid amount and issue to the company concerned a notice of assessment of the unpaid amount.

(9) If any company fails to pay any amount of secondary tax on companies in full within the period concerned contemplated in subsection (7), interest shall be paid by such company on the balance of the tax outstanding at the prescribed rate reckoned from the end of the period concerned.

(10)

(11) The provisions of this Act relating to the assessment and recovery of normal tax and additional tax in the event of default or omission shall with the changes required by the context *mutatis mutandis* apply in respect of secondary tax on companies.

(12)(a) Any company which on 17 March 1993 was engaged in mining for gold, may by notice in writing furnished to the Commissioner not later than 31 August 1993, elect to be exempt from the payment of secondary tax on companies.

(b) Any company which after 17 March 1993 commences mining for gold may by notice in writing furnished to the Commissioner not later than six months after the date on which it so commences, elect to be exempt from the payment of secondary tax on companies.

(c) An election made in terms of paragraph (a) or (b) shall, subject to the provisions of paragraph (e), be binding upon the company in respect of all future dividends declared by it.

(d) The exemption under this subsection shall apply to all dividends declared by the company concerned, whether payable out of profits derived from mining for gold or otherwise.

(e) Where any company which has made an election in terms of paragraph (a) or (b) ceases mining for gold during any year of assessment, the exemption under this subsection shall not apply to any dividend declared by such company during any subsequent year of assessment.

(13) In the determination of the net amount of any dividend declared by a company which carries on long-term insurance business, the amount to be taken into account in terms of subsection (3) in respect of dividends accrued to the company shall be limited to dividends accrued on shares constituting an asset in its corporate fund.

(14)

(15)

(16)

(17)

A3. Section 64C

64C. Certain amounts distributed deemed to be dividends.—(1) For the purposes of this section—

“**recipient**”

“**share incentive scheme**” means a scheme in terms of which not more than 20 per cent of the equity share capital of a company is—

- (a) held by the directors and full-time employees of—
 - (i) such company; or
 - (ii) an associated institution, as defined in paragraph 1 of the Seventh Schedule, in relation to such company,
 in terms of a share incentive scheme carried on for their own benefit;
- (b) held by a trustee for the benefit of such directors and employees under a scheme referred to in section 38(2)(b) of the Companies Act, 1973 (Act 61 of 1973); or
- (c) collectively held by such directors and full-time employees, and such a trustee.

(2) For the purposes of section 64B, an amount shall, subject to the provisions of subsection (4), be deemed to be a dividend declared by a company to a shareholder, where—

- (a) any cash or asset is distributed or transferred by that company to or for the benefit of that shareholder or any connected person in relation to that shareholder;
- (b) the shareholder or any connected person in relation to that shareholder is released or relieved from any obligation measurable in money which is owed to that company by that shareholder or connected person, to the extent that the amount so owed was not already deemed to be a dividend declared by that company in terms of paragraph (g);
- (c) any debt owed by the shareholder or any connected person in relation to that shareholder to any third party is paid or settled by that company;
- (d) any amount is used or applied by that company in any other manner for the benefit of the shareholder or any connected person in relation to that shareholder;
- (e) that amount represents additional taxable income or reduced assessed loss of that company by virtue of any transaction with the shareholder or a connected person in relation to such a shareholder, the consideration of which is adjusted

or any amount of interest, finance charge or other consideration is disallowed as a deduction in accordance with the provisions of section 31;

- (f) the company ceases to be a resident to the extent profits and reserves of that company are available for distribution immediately before so ceasing to be a resident (including any amount deemed in terms of the definition of “dividend” in section 1 to be a profit available for distribution): Provided that any prohibition or limitation on any distribution contained in the company’s memorandum and articles of association or founding statement or any agreement must be disregarded;
- (g) any loan or advance is granted and made available to that shareholder or connected person in relation to that shareholder;
- (h) that amount is incurred by that company in terms of an instrument in respect of which section 8F applies:

Provided that, for purposes of this subsection, in determining whether a person is a shareholder in relation to any company, no regard must be had to any share that is a listed share.

(3)

(4) The provisions of subsection (2) shall not apply—

- (a) where the amount constitutes a dividend or would have constituted a dividend but for the provisions of paragraphs (e) to (i), inclusive, of the definition of “dividend” in section 1;
- (b) where the amount constitutes remuneration in the hands of the shareholder or any connected person in relation to that shareholder or the settlement of any debt owed by the company to the shareholder or connected person;
- (bA) to the extent of any consideration received by that company in exchange for—
 - (i) the cash or asset distributed, transferred or otherwise disposed of; or
 - (ii) any other benefit granted as contemplated in subsection (2);
- (c) to so much of any amount (other than an amount contemplated in subsection (2)(e)) as exceeds the company’s profits and reserves which are available for distribution, including any amount deemed in terms of the definition of “dividend” in section 1 to be a profit available for distribution: Provided that any prohibition or limitation on any such distribution contained in the company’s memorandum and articles of association or founding statement or any agreement shall be disregarded in the application of this paragraph;
- (d) to any loan granted in respect of which a rate of interest not less than the “official rate of interest”, as defined in paragraph 1 of the Seventh Schedule is payable by the shareholder or any connected person in relation to the shareholder;
- (e) to any loan granted to the shareholder or any connected person in relation to the shareholder if the shareholder or connected person is an employee of the company or an associated institution contemplated in paragraph 1 of the Seventh Schedule in relation to the company and such loan is granted under, and in compliance with the normal terms and conditions of, a loan scheme generally available to employees of the company or of the associated institution who are not shareholders;

- (f) to any loan or credit granted to a shareholder of the company or any connected person in relation to the shareholder during any year of assessment of the company granting the loan or credit, if—
- (i) such loan or credit is repaid or otherwise extinguished by not later than the end of the immediately succeeding year of assessment;
 - (ii) the amount thereof is not included in any subsequent loan or credit granted to the shareholder or any connected person in relation to the shareholder; and
 - (iii) the provisions of this paragraph have not been applied in the case of the company in any previous year of assessment;

(g)

(h)

- (i) to any loan or credit granted to a trust by a company to enable that trust to purchase shares in that company or the controlling company in relation to that company with a view to the resale of those shares by that trust to employees of that company, under a share incentive scheme operated by the company for the benefit of those employees;

(j)

- (k) to any amount contemplated in subsection (2)(a), (b), (c), (d) or (g) distributed, transferred, released, relieved, paid, settled, used, applied, granted or made available for the benefit of—

- (i) a shareholder forming part of the same group of companies as the company that is deemed to have declared the dividend; or
- (ii) a connected person in relation to a shareholder if the connected person and the shareholder form part of the same group of companies as the company that is deemed to have declared the dividend:

Provided that if the profits of the company declaring the deemed dividend are reduced as a result of the dividend, this paragraph applies only to the extent that the profits of the shareholder or connected person, as the case may be, are correspondingly increased; and

- (l) to any amount contemplated in subsection (2)(a), (b), (c), (d) or (g) distributed, transferred, released, relieved, paid, settled, used, applied, granted or made available by a company for the benefit of any other company if—

- (i) the company (whether alone or together with any other company forming part of the same group of companies as the company) directly or indirectly holds at least 20 per cent of the total equity share capital of that other company; and
- (ii) that other company does not hold any equity shares in the company, or in any company forming part of the same group of companies as the company.

(5) Where any loan granted by a company to a shareholder or any connected person in relation to the shareholder—

- (a) was deemed to be a dividend declared by the company in terms of this section; and
- (b) is thereafter wholly or partly repaid by the shareholder or connected person,

the amount so repaid shall for the purposes of section 64B be deemed to be a dividend which accrued to the company concerned on the date on which such amount was repaid.

(6) For purposes of this section and section 64B, the dividend contemplated in subsection (2) shall respectively be deemed to have been declared by the company on the date that—

- (a) the cash or asset is distributed or transferred as contemplated in subsection (2)(a);
- (b) the obligation is released or relieved as contemplated in subsection (2)(b);
- (c) the debt is paid or settled as contemplated in subsection (2)(c);
- (d) the amount is used or applied as contemplated in subsection (2)(d);
- (e) the loan or advance is made available as contemplated in subsection (2)(g); or
- (f) the amount is incurred as contemplated in subsection (2)(h).

Amendments – 26 October 2010

1. Table of cases and footnotes – The South African Law Reports reference has been inserted in *Defy Ltd v C: SARS*.

2. Paragraph 2.4.2 – The effective date of the amendment to para (a) of the definition of a 'dividend' effected by the Revenue Laws Amendment Act 35 of 2007 has been inserted in Table 1.

3. Paragraph 3.10.4 – A comment on 'manufactured dividends' has been inserted.