Section 10B(3) sets out a formula for exempting *part* of a foreign dividend. It only applies to foreign dividends which are not exempt from tax in terms of *section 10B(2)*. The exemption is calculated in terms of a formula:

(A = B x C)

A = the amount to be exempted for a year of assessment

B = the ratio of the number 25 to the number 45 where the recipient of the dividend is a natural person, deceased estate, insolvent estate, or a trust. (Prior to 1 March 2017, the ratio was 26 to 41.)

B = the ratio of the number 8 to the number 28 where the recipient of the dividend is *not* a natural person, deceased estate, insolvent estate, or a trust. (Prior to 1 March 2017, the ratio was 13 to 28.)

B = the ratio of the number 8 to the number 28 where the recipient of the dividend is *an insurer* in respect of its company policyholder fund, corporate fund, and risk policy fund. (Prior to 1 March 2017, the ratio was 13 to 28.)

B = the ratio of the number 10 to the number 30 where the recipient of the dividend is *an insurer* in respect of its individual policyholder fund. (Prior to 1 March 2017, the ratio was 15 to 30.)

C = the aggregate of any foreign dividends received by or accrued to a person during a year of assessment that is not exempt from normal tax in terms of *section 10B(2)*

The *section 10B(3) exemption* is best explained by means of examples.

Example 1 - Foreign dividend received by natural person, deceased estate, insolvent estate, or trust

Mr F receives a foreign dividend of R10 000 ($1 200) on shares listed on the New York Stock Exchange. He is on a marginal tax rate of 45%. He incurred interest of R2 000 on a loan to purchase the shares in respect of which the dividend was received.

Gross income	R10 000
Section 10B(3) exemption – 25/45 x 10 000 =	(5 556)
Amount of dividend included in income	R4 444
Expenditure in production of dividend (R2 000)	-
Included in taxable income	R4 444
Tax at 45%	R2 000

Example 2 - Foreign dividend received by companies.

G (Pty) Ltd receives a foreign dividend of R10 000 ($720) on shares listed on the New York Stock Exchange. G (Pty) Ltd also incurred interest of R2 000 on a loan to purchase the shares in respect of which the dividend was received.

Gross income	R10 000
Section 10B(3) exemption – 8/28 x 10 000 =	(2 857)
Amount of dividend included in income	R7 143
Expenditure in production of dividend (R2 000) (see note below)	-
Included in taxable income	R7 143
Tax at 28%	R2 000

The effective rate of tax on the foreign dividend is therefore 20% (prior to 1 March 2017 it was 15%).

Note: *Section 23(q)* disallows the deduction of any expenditure incurred in the production of income in the form of foreign dividends.

See, also, chapter 19.2.13

Annuities and payments out of foreign dividends

Section 10B(5) states that the tax exemptions in subsections (2) and (3) do not apply in respect of any portion of an annuity or any other payments *out of* any foreign dividend. The underlined words were added with effect from the date of promulgation of the 2017 Taxation Laws Amendments.

Zanga

Gross income on sale of trading stock		R3 000 000
Cost of trading stock (section 11(*a*))		(3 750 000)
Trading stock of shares acquired at cost	(4 000 000)	
Excess of stock over share value	1 000 000	
Section 11(*a*) deduction	(3 000 000)	
Closing stock at year end (section 22(1))	3 000 000	nil
Taxable income/(loss)		(R750 000)

ABC

Capital gain made by company on issue of shares (R4 000 000 – 3 000 000)	R1 000 000
Include 80% in taxable income	800 000
Proceeds on sale of stock	4 800 000
Cost of stock (section 40CA)	(3 000 000)
Taxable income	R2 600 000

The result of the above is that Zanga makes a loss, but the shares acquired come into its books at a lower cost. In addition, ABC's cost of the asset acquired is less than the asset's market value. The result is tax inefficient for both companies. ABC is especially penalized, because it is taxed on a capital gain of R1 million, but cannot add this to the cost of the asset (because of the operation of section 40CA).

Value of shares more than value of asset (section 24BA(3)(*b*))

Where the market value of the shares immediately after the issue exceeds the market value of the asset immediately before the disposal, the result is as follows:

1) The excess is deemed to be a dividend *in specie*
2) Paid by the company on the date of that issue

By deeming the excess to be a dividend *in specie*, the company is responsible for the 20% dividends tax (unless an exemption applies, such as where the asset is acquired from another company).

Example – Value of shares are more than value of assets received
The Zanga Trust sells trading stock (which cost R2 750 000) to ABC (Pty) Ltd in return for 5% of the ordinary shares in ABC (Pty) Ltd. These are the only shares which Zanga holds in ABC. The value of the trading stock is R3 million, and the value of the shares received is R4 million. Zanga receives and holds the shares in ABC as trading stock. These shares are still on hand at the end of Zanga's year of assessment.

ABC acquires Zanga's trading stock as a capital asset, but due to a good offer which it receives, it sells the 'trading stock' for R4,8 million during the year of assessment. Assume that the R4,8 million receipt is capital in nature.

Zanga Trust

Gross income on sale of trading stock		R4 000 000
Cost of trading stock (section 11(*a*))		(2 750 000)
Trading stock of shares acquired at cost	(4 000 000)	
Closing stock at year end (section 22(1))	4 000 000	nil
Taxable income		R1 250 000

ABC (Pty) Ltd

Capital gain made by company on issue of shares	R000
Proceeds on sale of capital asset	4 800 000
Cost of capital asset (section 40CA)	(4 000 000)
Capital gain	R800 000
Include 80% in taxable income	R640 000
Taxable income	R640 000

In addition to the above, ABC is liable for dividends tax of 20% of (R4 m – R3), i.e. R200 000, payable by the end of the month following the date of issue of the shares.

GROSS INCOME	R16 410 000
Less: Exempt income	nil
INCOME	R16 410 000
Less: Deductions	
Cost of listed shares (section 11(*a*) and section 22)	(1 410 000)
Running costs (section 11(*a*))	(1 200 000)
Repairs (section 11(*d*))	(900 000)
TAXABLE INCOME BEFORE DISTRIBUTIONS	R12 900 000

Gross income is R16 410 000 up to date of distribution. 75% of this total is R12 307 500. The rental is more than this, so any distribution will be a 'qualifying distribution'. The deduction of the total of the interest expense and dividend distribution will be limited to R12 900 000.

Qualifying distribution	
- Interest	(10 000 000)
- Dividend	(1 330 000)
TAXABLE INCOME	R1 570 000
Capital gain on sale of buildings (disregard)	-
TAXABLE INCOME	R1 570 000
Tax per table (28%)	R439 600

(*b*) *Distribution*

	Resident Individuals	Resident companies	Non-resident companies
Interest	R3 500 000	3 500 000	3 000 000
Dividend	465 500	465 500	399 000
	R3 965 500	3 965 500	3 399 000
Dividends tax (20%)	-	-	R679 800

South African resident companies are exempt from dividends tax on dividends received. In any event, there is no dividends tax on the amounts paid by a REIT to South African residents, because the distributions are subject to normal income tax. The perceived benefit of the distribution being taxable is that if an investor borrowed funds to make the investment, the interest on the borrowing is tax deductible. I have a concern that, because the income from the REIT is deemed to be taxable dividend income in the hands of the debenture holder, it is *not trade income* and section 24J may not apply to allow the deduction of the related interest expense. On page 525 of issue 6 of the SARS Comprehensive Guide to Capital Gains Tax, however, the writer takes the view that the interest is deductible.

Example 2 - REIT

The ABC REIT (Real Estate Investment Trust) LTD was formed on 1 April 2017 and was listed on 3 April 2017. It issued 10 million shares at R1 each, with each share linked to a loan account of R99. In this way it raised R1 billion. The funds were used to purchase 15 buildings which were held as capital assets in order to earn rental income.

The transactions of the company for its first period of assessment ended 31 December 2017 are as follows:

Rental income	R48 000 000
Interest income	3 000 000
Deductible expenses	(6 000 000)
Proceeds on sale of building	62 000 000
Cost of building	(40 000 000)
Interest paid to shareholders	(50 000 000)
Dividend paid	(10 000 000)

YOU ARE REQUIRED

It is important to note that s 24L merely deals with the determination of the amounts accrued or incurred. It does not provide for the taxation or deduction of the amounts; that must be done in terms of the normal gross income and s 11(*a*) provisions.

Example – Premium on option contract

A taxpayer (X) pays a premium of R600 000 for an option to take up shares at an agreed price of R1 million when the market value of the shares is R1 million. The premium of R600 000 must be spread over the option contract period.

However, if the premium includes an amount representing the intrinsic value of the option the premium must be reduced by such amount. If, for example, the market value of the shares was R1,5 million when the option was granted the position is as follows:

Intrinsic value is R1 500 000 (market value) - R1 000 000 (strike price) = R500 000

Therefore:

- R100 000 (being R600 000 - R500 000) of the premium is deducted on a day-to-day basis over the term of the option contract; and
- R500 000 (the intrinsic value) is deducted when the option is exercised.

17.8 DIVIDENDS DEEMED TO BE INCOME

17.8.1 HYBRID EQUITY INSTRUMENTS

Section 8E is aimed at combating schemes in which shares are used to facilitate what is in substance a loan. If a lender makes a loan to a borrower any interest received on the loan is taxable. If instead of a loan the lender is given preference shares (redeemable after the loan period would have expired) the lender receives tax free dividends instead of interest.

The effect of section 8E is (when it applies) to deem the dividends to be income in the recipient's (the lender's) hands. Note that for the company paying the dividend it remains a dividend paid, however, due to the fact that it is treated as income in the hands of the recipient, it is not subject to dividends tax.

Application

The application of section 8E is simple. It deems *dividends* and foreign dividends accrued to or received by a person to be *income* (as defined) if the dividend or foreign dividend is paid on a *hybrid equity instrument.*

Being 'income' the dividend cannot be exempted from tax, and neither can the interest exemptions apply.

- The section applies if the share was a hybrid equity instrument *at any time* during the year of assessment.

Definitions

'equity instrument' - A definition of 'equity instrument' is inserted in section 8E to cover any *right or interest* if the value of that right or interest is determined directly or indirectly with reference to a share or an amount derived from a share. This applies in respect of years of assessment ending on or after 1 January 2017. This is to counter schemes where hybrid equity instruments are held through trusts, with the holder having a right or interest in the trust.

'**hybrid equity instrument**' is the longest and most important definition in the provision. It deals with 3 types of shares which could be 'hybrid equity instruments'. i.e. –

a) A share (other than an equity share) if at least one of the following applies -
   - ✓ the issuer of the share (the company) is obliged to redeem it in whole or in part within a period of 3 years from the <u>date of issue</u>
   - ✓ the share may, at the option of the holder, be redeemed in whole or in part within a period of three years from the <u>date of issue</u>.

b) Any other share if at least *one item* (✓) applies from *both* of the blocks below –

✓ the issuer of the share is obliged to redeem it in whole or in part within 3 years from the <u>date of issue</u>
✓ the share may, at the option of the holder, be redeemed in whole or in part within 3 years from the <u>date of issue</u>
✓ on the <u>date of issue</u> of the share the existence of the company issuing the share is to be terminated (or likely to be terminated) within a period of 3 years

and

During the year the company pays a dividend of R5 per share. Calculate the tax payable on this dividend. Assume that Mr Justin is on the maximum rate of tax of 40%.

Gross income (dividends accrued)	R500 000
Less: Section 10(1)(*k*) exemption	(500 000)
Income	nil
Dividends tax withheld by company (R500 000x20%)	R100 000

Even though the shares may, at the option of the shareholder, be redeemed within 3 years of the date of issue, they are not hybrid equity instruments, because they are equity shares and they share equally in dividends with the ordinary shares. An 'equity share' is defined in section 1 as any share where the right to participate either in dividends or in capital is not limited. Therefore, although the right to share in capital is limited, the share is still an equity share, because the right to share in dividends is not limited.

Example – hybrid equity instrument

Needlot (Pty) Ltd (the issuer) issues R1m worth of redeemable preference shares to Havenot (Pty) Ltd (the shareholder). The preference shares entitle the holder to an annual preference dividend at the rate of 70% of the weighted average of the prime rate charged by banks. The shares are redeemable at the request of Havenot at the same amount which it subscribed for the share.

In the first year, Needlot pays a preference dividend of R90 000. The tax effects are as follows:

Havenot (Pty) Ltd

- The dividend of R90 000 is taxable as income. This is because the share is not an equity share. The dividend is fixed (at a percentage of the prime interest rate), *and* it is redeemable at the option of the holder within 3 years of the date of its issue.

Needlot (Pty) Ltd

- No deduction is allowed in respect of the R90 000 dividend paid.
- The dividend is not subject to Dividends Tax, because although it is still a dividend from the point of view of the company which pays it, it is income in the hands of the shareholder.

Section 8E(2A) was introduced from 19 January 2017. It provides that where a share was issued in terms of an agreement concluded before 1 April 2012, and it is a hybrid equity instrument *solely* by virtue of a right of redemption or a security arrangement, and the right or arrangement is cancelled on or after 26 October 2016 and on or before 31 December 2017, then section 8E will not apply to any dividend or foreign dividend accruing in respect of the share after the date of cancellation of the right or arrangement, and the cancellation of the right or arrangement is not treated as a disposal of that share if no consideration is payable in respect of the cancellation. This is merely to avoid any application of the anti-avoidance rules if the parties to the arrangements cancel them during this window period.

Summary

A hybrid equity instrument is a share in a *company* that has more debt characteristics than equity characteristics. For this reason, *sections 8E and 8EA* of the Income Tax Act treat dividends on those shares as income. Interestingly, the income is not treated as interest income, and the company is not granted a tax deduction of the dividend that the shareholder is taxed on. As the dividend is treated as 'income' the dividend exemption cannot apply.

17.8.2 DIVIDENDS ON THIRD-PARTY BACKED SHARES

Section 8EA deems any dividend or foreign dividend received by or accrued to a person to be *income* if the share is a *third-party backed share* at any time *during* the year of assessment. Being 'income' as defined, it cannot be exempted from tax, whether received by a resident or a non-resident person.

Third-party backed share

Section 8EA(1) defines a 'third-party backed *share*' as any *preference share* or *equity instrument* (as defined in the section) in respect of which there is -

- ✓ an *enforcement right* exercisable by the holder of the share, or equity instrument, or
- ✓ an *enforcement obligation* is enforceable

lend money to Company Y on condition that Company H agree to back rank its loan claim against Company Y. Therefore, Company Y and Company H agreed that Company Y would pay 3% per annum interest on the loan from Company H, but would not repay any part of the capital until the market value of the assets of Company Y equalled or exceeded the amount of the liabilities. The interest was payable in cash by the last day of February each year. The year end of the companies is the last day of February. It is likely that the capital amount of the loan will only be repayable on 28 February 2020. No audit certificates were acquired by the company in regard to the subordination. On 1 March 2017, Company H sold the back ranked loan to Trust V for R7 million. The tax positions of Company Y and Trust V are as follows:

Company Y

The interest paid of R8 million x 3% is not tax deductible. It is subject to dividends tax of 20%, that must be withheld by Company H. This is a deemed dividend *in specie,* which means that the tax must be borne by Company Y -

R8 000 000 x 20% R1 600 000

Trust V

The interest of 3% per annum, received by Trust V is a deemed dividend, therefore it is exempt from tax in terms of section 10(1)(*k*) of the Income Tax Act.

Insofar as the purchase of the debt at a discount is concerned, the discount is deemed to be interest in the hands of the holder (Trust V) in terms of section 24J – see paragraph (*a*) of the definition of 'interest' in section 24J. The date of redemption of the instrument is likely, on a balance of probabilities, to be 28 February 2020. See the definition of 'date of redemption' in section 24J.

Taking into account the discount of R1 million, and the annual interest of 3%, the yield to maturity of the instrument is 6,7%. However, as the interest is deemed to be a dividend, only the discount must be taken into account to calculate the yield to maturity in terms of section 24J. The yield to maturity in this case is just more than 3,3%. We will use 3,3% for the purposes of this example.

The interest deemed to be earned by Trust V for the year of assessment ended 28 February 2018 is:

R7 000 000 x 3,3% R231 000

This amount is taxed as income in the hands of Trust V, even though the loan is a hybrid debt instrument in terms of section 8F. The reason that the discount is not a dividend, is because it is not incurred by Company Y. It first has to be treated as a dividend from Company Y's point of view, before it may be treated as a dividend in Trust V's hands.

Section 8F(1)(c) lists the last type of 'hybrid debt instrument' as one in which a company owes an amount to a 'connected person' and is not obliged to redeem the instrument *within 30 years from the date of issue of the instrument*. Where the company has the right to convert or exchange that instrument (debt) for another one, the two instruments must be treated as one when looking at the 30-year redemption obligation.

Example – hybrid debt instrument

Company S, a South African company, borrowed an amount of R10 million from its holding company (Company H) in France. The loan was granted on 1 January 2016, the beginning of Company S's year of assessment, and was denominated in South African Rands. It bore interest at 5% per annum. The loan agreement states that the loan is repayable by 31 December 2025 (the termination date), and could be paid off earlier, but is subject to the condition that should any portion of the Principal Amount still be outstanding as at the Termination Date, the Board of Directors of the Borrower ("Company S") shall in its discretion be entitled to determine that any amount thereof be repaid on terms approved by the Board. This means that the Borrower decides when to repay the loan. The Lender does not have the power to force the Borrower to pay.

This is an abnormal aspect of any borrowing. The Income Tax Act, in section 8F, contains a provision that deems the interest on such a loan to be a dividend (both for the borrower and the lender), because the loan is treated (in substance) as share capital. The loan is referred to as a 'hybrid debt instrument', because the loan is not a demand instrument, and the company is not *obliged* to repay the loan within 30 years from the date of issue.

Section 8F came into effect for all amounts of interest expenditure incurred on or after 1 April 2014. This means that Company S has to withhold dividends tax, at a rate of 5% on all amounts of interest paid to its shareholder in France. If the interest is not paid to a shareholder that is a company holding directly at least 10% of Company S, then the rate of dividends tax is 15%. This is in terms of article 10 of the Double Tax Agreement between South Africa and France.

So, for example, if Company H held all the shares in Company K, which held all the shares in Company S, then the interest paid by Company S to Company H would be subject to dividends tax at the rate of 15%. In addition, where section 8F applies, Company S cannot claim a tax deduction of the interest.

- to avoid, reduce or postpone the liability for tax

The reason that this onus is put on the taxpayer is that SARS cannot prove what the taxpayer's intention was. It is therefore assumed that his intention was to use the assessed loss until he proves otherwise.

20.6 DIVIDEND/INCOME SWAPS

Section 103(5) is an anti-avoidance provision aimed at transactions, operations or schemes under which a taxpayer has ceded his right to receive any amount in exchange for a right to receive any amount of dividends. The section requires the Commissioner to determine the normal tax liability of the taxpayer or any other party to the transaction as if the cession had not been effected.

The subsection only applies if the normal tax of one or both of the parties to the agreement is *reduced* or *extinguished* because of the cession.

Example – Dividend/rental swap

Trust X receives rental income of R400 000 per month, which is taxable in its hands. It has no expenses, so it earns R240 000 per month after tax. Company Y had an assessed loss of R3 million, and earns some trading income, and receives dividends of R310 000 per month. The dividends are tax free.

Trust X cedes its rental income to Company Y and Company Y cedes its dividend income to Trust X. The company and the trust feel that this is a fair swap.

Before (per month)	***Trust X***	***Company Y***
Rental	R400 000	
Dividends (exempt)		R310 000
Tax at 40%	(160 000)	-
After tax	R240 000	R310 000
After (per month) – before applying section 103(5)		
Rental		R400 000
Dividends	R310 000	
Tax	-	-
After tax	R310 000	R400 000

Company Y's assessed loss shields it from tax.

SARS applies section 103(5)	***Trust X***	***Company Y***
Rental		R400 000
Dividends	R310 000	
Tax (ignoring cession)	(160 000)	-
After tax	R150 000	R400 000

Trust X is worse off, because s 103(5) does not undo the cession, it merely allows SARS to tax Trust X *as if* the cession did not take place.

Notes to section 103(5) – Cross cessions

- *Section 103(5)* does not give the Commissioner any discretion. If the requirements of the section are satisfied, the Commissioner *has* to determine each person's tax *as if* the cession had not taken place.
- If the cross-cession does *not* result in a reduction of normal tax in the hands of the person ceding the income which is taxable, the section does not apply.
- If a cross cession has the result that a company receives a dividend which was ceded to it, such dividend will be subject to normal tax in the hands of the company. The company will not be entitled to the dividend exemption. See the discussion of section 10(1)(*k*) in chapter 4.
- The cession of the dividend to Trust X has the result that the dividend is subject to the 20% dividends tax, because the cession of the dividend has had the result that the trust is the beneficial owner of the dividend (per the definition of 'beneficial owner' in section 64D).

each year of assessment. The form contains details of the tax in dispute, any penalties, additional tax, and interest.

7. The question of the grounds of objection was one of the issues in the case *Matla Coal Ltd v CIR* (1987 AD). *Matla* had objected to an amount being taxed on the grounds that it was a capital receipt resulting from the sale of mining rights. In the case that followed *Matla* based its argument on the fact that the payment was a restraint payment. The Commissioner argued that *Matla* could not argue restraint, but was bound to the original argument that the amount was received for the sale of mining rights. The court felt that it did not have to be unduly technical or rigid in its approach to interpreting the objection. It decided that it had to look at the substance of the objection to see whether it covered the argument the taxpayer wanted to put forward. It concluded that the basic objection was that the amount was capital and *Matla* had not deviated from that point.
8. Where the objection does not comply with the above requirements the Commissioner has 30 days to notify the taxpayer. If he does not do so, the objection will be deemed to be valid.
9. The regulations (rule 52) under the TAA give the taxpayer recourse to the Tax Court if SARS states that a tax objection is invalid. SARS has to give reasons for the objection being invalid (rule 7(4)). An approach to the High Court is therefore not the only option open to the taxpayer (see *Nondabula v CSARS and another* [2017] ZAECMHC 21 (27 June 2017)).
10. The Commissioner has 30 days to request the information, documents or things required to decide on the taxpayer's objection and the taxpayer then has 30 days to comply.
11. On timeous request by the taxpayer he may be given a further 30 days to comply.
12. The Commissioner has 60 days after the objection to decide on it (or 45 days after receiving the further information requested).
13. If the matter is complex, or the circumstances exceptional, the Commissioner may take a further 45 days to decide the matter, and must inform the taxpayer of the delay. This delay may also be because of the legal principle or the amount involved.
14. On receipt of an objection from a taxpayer the Commissioner may allow part or all of the objection and issue a revised assessment or he might disallow it (section 106 of the TAA).
15. If the Commissioner disallows the objection, he must notify the taxpayer. If the objection is disallowed in whole or in part, the taxpayer may appeal against that decision (section 107 of the TAA).

► *ITC 1785* (2004, 67 SATC 98) dealt with two important issues relating to objection. Following an investigation of the taxpayer's affairs by SARS, additional assessments were issued. As a result of the additional assessments the taxpayer retained the services of a firm of tax consultants. In the course of their services the consultants discovered that the taxpayer had failed to claim a tax deduction, in respect of foreign exchange losses. The taxpayer objected to the additional assessments and claimed the foreign exchange losses.

The Commissioner's contention was twofold. Firstly, the Commissioner contended that the appellant had no right to rely upon its own omission in the original return as a basis for objecting to the revised assessments. Secondly, it was contended that the objection was limited to aspects directly relevant to the revised assessments and not to those which had been taken into account and dealt with in the original assessments.

The court's findings on these two issues is worth covering.

1. ***Can taxpayers rely on their own omission as a basis for objecting to an assessment?***
   - The Act confers the right to object upon *a taxpayer who is aggrieved by any assessment*.
   - It is clear that a taxpayer whose taxable income has been determined on an erroneous basis is always 'aggrieved' even if the source of the error in entirely attributable to him.
   - The court held that he could object in the circumstances.
2. ***Is the right of objection to a revised assessment limited to the matters germane to the revision?***
   - *Section 81(1)* at the time read as follows:

     > "Objections to any assessment made under this Act may be made within 30 days after the date of the assessment in the manner and under the terms prescribed by this Act by any taxpayer who is aggrieved by *any assessment in which he is interested*."

     (Section 104 of the TAA reads 'aggrieved by an assessment made in respect of the taxpayer'.)