Pieter van der Zwan & Associates

Tax & IFRS advisors

Tax Developments on one page

Tax implications of ceded dividend rights

The favourable tax treatment of dividends makes it susceptible to be used as a mechanism to disguise other income in a manner to also enjoy this treatment. The KWJ case deals with an instrument that provided the taxpayer with a yield in the form of antecedent dividend rights. Specifically, the judgment considered the timing and nature of the accrual to the taxpayer in such a case.

Dividend income is subject to tax treatment, which if viewed only from the perspective of the recipient thereof, is more favourable than most other income. It is exempt from normal tax. Dividends paid by one South African company to another are furthermore exempt from dividends tax. This treatment makes dividends susceptible to be used as a mechanism to disguise other amounts in an attempt to also enjoy this favourable treatment. A good example is arrangements to dispose of shares while extracting the sales proceeds in the form of a dividend, as was recently targeted by the anti-dividend stripping rules introduced at the start of the year.

This article reviews a case recently heard in the SCA (*CSARS v KWJ Investments*) that deals with a cession of dividend rights.

Case facts

The taxpayer, KWJ Investments (KWJ), conducted business in redeemable preference shares. It issued these shares to investors and invested the proceeds in other instruments to profit from the difference between the dividends paid and investment yield. The transactions that the appeal relate to involved an investment by KWJ in a composite note issued by Investec. The note provided KWJ with a return on its investment in the form of an antecedent cession of the rights to identified dividends declared by listed companies but not yet paid. The amount of these ceded dividends was determined in accordance with a formula. Investec acquired the rights to the dividends from Old Mutual and Sanlam and on-ceded it to KWJ. KWJ was entitled to the repayment of the capital invested in the note.

SARS contended that an amount, which was not a dividend, accrued to the taxpayer when it became entitled to the ceded dividend rights. A second accrual followed when the dividends were paid by the listed company. The taxpayer took the view that the only accrual occurred when the dividends were paid to it. It argued that this accrual qualified for the exemption applicable to dividends.

Judgment

Davis AJA concluded that the accrual of the right to receive the dividends was an unconditional accrual of an amount to KWJ, even though the dividend rights were not yet enforceable. The dividend rights constituted a form of property that had a monetary value. This value was evident from the price that Investec was willing to pay Sanlam and Old Mutual to acquire the dividend rights.

The amount of this accrual had to be included in gross income. This amount did not represent a dividend and did not qualify for exemption. The court did not express a view as to whether the amount fell within the ambit of section 24J, which deals with interest. Despite the fact that the SCA agreed with the SARS view on the technical aspects of the case, SARS' appeal was unsuccessful as it was held that the assessments prescribed on the basis of practice generally prevailing at the time.

Current law

The KWJ case related to transactions that occurred during 2008 and 2009. Specific anti-avoidance provisions in respect of ceded dividends were since introduced in section 10(1)*(k)*(i)*(ee)*.

Section 64EB contains deemed beneficial ownership rules aimed at similar arrangements that aim to exploit from dividends tax exemptions.

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Contact Pieter van der Zwan
+27 83 417 5904 or
pieter@pvdz.co.za
www.pvdz.co.za