New tax rules for returns of capital

Some shareholders may prefer returns of capital over dividends. The rules relating to returns of capital and contributed tax capital were susceptible to disproportionate returns of capital to such shareholders over time. Two further restrictions are introduced to curb this practice.

The National Treasury published the Taxation Laws Amendment Bill for 2022 on 26 October 2022. Amongst others, this bill includes an amendment that affects returns of capital. This is the outcome of a process that started in 2021.

Principles of returns of capital

When a company makes a distribution to its shareholders, that distribution is either classified as a dividend or a return of capital for tax purposes. A return of capital represents a distribution made from a company's contributed tax capital (CTC). CTC essentially consists of the amounts contributed to the company when it issued shares.

A shareholder reduces the base cost of shares held on capital account with any returns of capital received without disposing of the shares. If the return of capital exceeds the base cost, this results in a capital gain. Any returns of capital upon the disposal of shares form part of proceeds from the disposal.

Distributions that are not returns of capital are dividends. They are generally exempt from normal tax but subject to dividends tax. Some beneficial owners qualify for an exemption or a reduced rate of dividends tax.

Shareholder preferences

Depending on the shareholder, a dividend or return of capital may be more favourable. A resident company in whose hands a dividend is exempt from normal tax and dividends tax may prefer a dividend. A foreign person not subject to capital gains tax on the disposal of shares may prefer a return of capital. This escapes tax in South Africa. Persons subject to dividends tax could similarly prefer a return of capital. This reduces the base cost of their shares and does not have any immediate tax implications, unlike dividends.

Due to these preferences, companies elected to make distributions to some shareholders as returns of capital (from CTC) and others as dividends. The rules for returns of capital determine that a transfer of CTC to a specific shareholder may not exceed that shareholder's proportionate share of the company's overall CTC. This rule applies to each transfer. It did not prevent the company's CTC from disproportionate allocation to some shareholders as returns of capital and others as dividends over multiple transfers.

Amendment

Two further restrictions on transfers from CTC aim to curb the above practice.

The first rule requires that a transfer may only be made from CTC if an equal amount is transferred to each share in respect of which the distribution is made. In the case of a distribution in the form of consideration paid for the acquisition, cancellation or redemption of a share, the same amount of CTC must be transferred to all shares in respect of which such consideration is paid.

The second restricts the amount of CTC transferred per share. This amount may not exceed the total CTC for the class divided by the total shares issued. It is unclear whether this second restriction will practically have any effect that the existing rule did not already achieve. My first impression is that it does not seem to.

The revised rules apply from 1 January 2023.

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+27 83 417 5904 pieter@pvdz.co.za www.pvdz.co.za