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Asset for share transactions – beware of selling your shares within 18 months especially in the context of a share buy-back

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To prevent tax considerations from discouraging the incorporation of a business, a specific form of 'rollover relief' is available when an asset is exchanged under an 'asset-for-share transaction'. The relief is set-out in section 42 of the Income Tax Act 58 of 1962 ("the Act") which applies automatically unless the parties elect for the relief not to apply.

INTRODUCTION

The basic principle underlying an 'asset-for-share transaction' is relatively simple: A natural person or legal persona may dispose of, to a resident company, in exchange for equity shares, capital assets the market value of which is equal to or exceeds their base cost – or trading assets the market value of which is equal to or exceeds their cost or value as closing stock – without being subject to capital gains tax ("CGT") or income tax on the gain. Instead (with certain exceptions) the capital gain or gross income that would have accrued to the transferor on disposal of the capital assets or trading stock is 'rolled over' and becomes taxable in the hands of the transferee company on disposal.

Further, when a transferor disposes of an allowance asset and the transferee company, in turn, acquires it as such, the corporate 'rollover relief' rules allow for the transferee to 'step into the shoes' of the transferor. The parties are deemed to be one and the same and amounts allowed to the transferor will not be recovered or recouped by him or included in his income in the year of transfer.

ANTI-AVOIDANCE RULES

The provisions of section 42 are subject to a number of specific so-called anti-avoidance rules that prevent the section from being misused by either the person selling the asset or the company issuing the shares.

One particular scenario is where a transferor disposes of the acquired equity shares in a transferee company within 18 months from date of acquisition, where immediately prior to the disposal 50% or more of the market value of the assets originally transferred is attributable to allowance assets, trading stock or both.

This particular anti-avoidance rule is found in section 42(5) of the Act. This section was amended in terms of the 2015 Taxation Laws Amendment Bill ("TLAB") with retrospective effect to 1 April 2015.

Prior to its amendment the rule provided that, if immediately prior to the disposal more than 50% of the market value of all the assets disposed of to the transferee company, was attributable to allowance assets or trading stock or both, the transferor would be deemed to have disposed of the equity shares as trading stock to the extent that any amount received or accrued was less than or equal to the market value of the shares at the beginning of the 18-month period.

In terms of the amendment in the TLAB, the disposal of the shares is no longer treated as a deemed sale of trading stock but is simply included in that person's income.

PURPOSE

The purpose behind the anti-avoidance rule is understandable in that it is aimed at preventing the tax arbitrage achieved by a transferor selling allowance assets and trading stock tax-free in terms of an asset-for-share transaction and shortly thereafter selling the equity shares acquired as a result, as capital assets.

The reason for the change was that the old wording which deemed the sale to be a sale of trading stock created unintended anomalies, which potentially converted the nature of the equity shares to assets held as trading stock. It was stated in the Explanatory Memorandum to the TLAB that the section be amended to clarify that the anti-avoidance provision only seeks to include the amount as gross income. Unfortunately, this was not the outcome as the amount is now automatically included in 'income' and not 'gross income' and while the change appears to be subtle, for the reasons explained below, its effect is potentially onerous.

If one considers the tax treatment of a dividend in the context of a share buy-back transaction, the subtlety and the effect of the amendment become clear. Ordinarily, a dividend is included in gross-income but is exempt from normal tax in terms of section 10(1)(k)(i) of the Act. As a result, a share buy-back, which comprises a dividend for tax purposes not only reduces the proceeds amount for CGT purposes but is also exempt from normal tax. However, if the Act deems an amount to be income, the inclusion in income effectively bypasses the exemption provisions in the Act which will have the effect of treating the amount received from a share buy-back as being subject to income tax.

SECTION 42(5)

Under the current provisions of section 42(5), if a person sells allowance assets to a company which meet the 50% threshold and in exchange receives equity shares which qualify for the roll-over treatment under section 42 and within 18 months the company repurchases the shares or some of the shares for an amount that constitutes a dividend for tax purposes, the proceeds received by the selling shareholder will be taxed as income. Whereas under the old rule and for that matter in terms of the intended change as communicated in the Explanatory Memorandum (ie to include the amount received in 'gross income'), the amount would be exempt from normal tax.

The effect is even more acute where the shareholder is a company as under the old rule the buy-back dividend would have been exempt from income tax and the 15% Dividend Tax. Now, under the new rule, the amount is included in income and subject to tax at 28%.

The onerous result is further compounded by the fact that the change applies retrospectively to 1 April 2015. Again, this does not appear to align with the intention of the legislature as it was formally stated in the Explanatory Memorandum to the TLAB that the amendments would come into operation on the date of promulgation, which would have been 27 November 2015 and not 1 April 2015.

Accordingly, taxpayers should be cognisant of potential tax implications for those transactions where allowance assets or trading stock which met the 50% threshold were sold in exchange for shares and those shares have subsequently been disposed of by means of a share buy-back concluded on or after 1 April 2015 and within 18 months of the original transaction.

CONCLUSION

Given the retrospective effect of the change and depending on the tax year-end, the shareholder subject to the share buy-back may be required to re-open its tax return and account for the income tax on the buy-back amount. Alternatively, the additional tax could be paid using the voluntary disclosure programme provisions in the Tax Administration Act.

Of course, the better outcome is for the section and its effective date to be changed in the 2016 Taxation Laws Amendment Bill so as to align itself with the original intention.

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