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DILUTING SHAREHOLDING TRIGGERS CGT: By Jonathan Hore

It often happens that businesses admit new shareholders who usually bring more capital to expand or sustain the business. The new shareholder is usually issued with new shares, which represent the capital injection. This seemingly innocent and prudent business decision is done with honest motives and equally, the tax consequences thereof are 'honestly' ignored. It is unlikely that one would imagine that admitting a new shareholder could trigger taxes. I want to analyse this principle of share dilution, which can expose many taxpayers. In this article, words importing the masculine shall be deemed to include the feminine.

What's share dilution?

Share dilution is a process whereby the shareholding of existing shareholders is reduced upon the admittance of additional owners. To put things into perspective, a shareholder who owns 100 shares in a company may issue 50 more shares to have more capital. Statistically, the old shareholder then holds 100 out of 150 shares, or 66.67% when he initially held 100 out of 100 shares, 100%. The 100% later gets reduced to 66.67%, i.e. a 33.33% decrease. One thing to note is that the old shareholder wouldn't have sold the shares and technically, no tax must arise in his hands.

Enter CGT

Capital Gains Tax or CGT is payable when someone sells taxable assets such as immovable property or shares. The tax is charged in the hands of the seller of the asset in question. The concept of the tax is that one realises a capital appreciation over the time they held the shares, technically making them 'richer.' For example, if one starts a company from scratch, the cost of the shares is usually depicted as P100, being P1 for each of the 100 shares. If the business grows, the shares may rise in price to say P2m, which means that the shareholder would have recognised a capital gain of P 1 999 900 (P2m- P100). Such gain is referred to as capital gains subject to tax at 25% at the highest bracket (individuals) or 22%/30% for companies.

Why CGT on dilution?

Well, the tax laws are rather complex and one needs to clearly look in between each of the words used before making a conclusion. CGT is not only charged on the sale of taxable assets as stated above but it is also levied on disposal of taxable assets through any form including donations, transfers on inheritances. Technically speaking, the Income Tax Act levies CGT on the 'disposal' of such taxable assets. The word, 'disposal' is further defined in the same Act as, 'relinquishment of the asset.' Dictionary.com defines, 'relinquishment' as to 'renounce or surrender (a possession, right, etc.): to give up.' So, the biggest question is whether diluting one's shares is a disposal.

Going back to our example, where a shareholder who initially held 100% shareholding ends up with 66,67%, what would have happened to the 33.33%? If one asks if he still possesses the 33.33%, he will get 'no' as an answer. However, if you ask whether the former shareholder, 'gave up' any shareholding, the answer will be in the affirmative. In other words, the shareholder disposes the 33.33%, albeit indirectly through allowing the other shareholder to take shares in the company. Consequently, the old shareholder tacitly 'disposed' of his 33.33%, in exchange for more capital for the company. The shareholding dilution therefore constitutes a disposal or giving up part of the initial 100%.

It is undeniable that in most of those arrangements, the old shareholder does not financially benefit from the new capital injection but he does as the company may become more profitable, purchase more assets or just be able to sustain operations which could have sunk.

Conclusion

It appears rather unfair to hold that share dilution triggers CGT. I had heated arguments with fellow tax colleagues who argued that no tax arises until we investigated other countries legislations and obtained written confirmation elsewhere that indeed CGT arises. Therefore, before you embark on any transaction, ask yourself whether you have checked its consequences.

Well folks, I hope that was insightful. As Yours Truly says goodbye, remember to pay to Caesar what belongs to him.