South African Institute of Tax Professionals

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Dear Ms. Mputa and Mr. Tomasek

RE: SUGGESTED REFINEMENTS TO CORPORATE TAX ISSUES INCLUDED IN ANNEXURE C OF THE BUDGET REVIEW 2015

Following the inclusion of the various corporate tax proposals in Annexure C of the Budget Review, the Corporate Tax Committee would like to assist by providing further input on some of these proposals.

We trust that this submission will assist you in the drafting process.

Should you have any further questions, please do not hesitate to contact me.

Yours sincerely,

Dawid van der Berg
Chairman: SAIT Corporate Tax Committee

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1 COMPANY ASSET-FOR-SHARE TRANSACTIONS (SECTION 42(5))

1.1 Inequities resulting from section 42(5) in respect of "gain" shares

Section 42(5) seeks to counter avoidance arrangements intended to indirectly convert ordinary revenue into capital gains. In the paradigm arrangement of concern, the taxpayer transfers assets mainly of a revenue nature to a company and then sells the shares of the company with the share sale claimed as a capital gain. Section 42(5) resolves the concern by treating the sale as ordinary in nature. In technical terms, section 42(5) applies if: (i) the subsequent share sale arises within 18 months after the section 42 asset-for-share transaction, and (ii) more than 50 per cent of the value of the assets disposed of by the taxpayer to the company in respect of which Part III applies consist of trading stock and/or allowances at the time of subsequent share sale.

The problem with the anti-avoidance rule is that the rule does not technically convert the capital gain from the share into ordinary revenue. The anti-avoidance rule simply deems the existence of trading stock equal to the gross value of the shares on the date of the initial section 42 transaction.

Example

Facts: A natural person enters into an asset-for-share transaction with a company in terms of which that person disposes of three assets to that company via section 42. These three assets consist of trading stock (with a R60 market value and an R58 cost price), an allowance asset (with a R42 market value and a R40 base cost) and a capital asset – typically goodwill (with a R98 market value and a zero base cost). In exchange for the assets, the natural person receives equity shares in the transferee company with a market value of R200 (and a total base cost of R100) on the date of disposal. The person subsequently sells the equity shares at market value for R270 within 18 months after the asset-for-share transaction to a non-connected person.

Result: Assuming section 42(5) applies, the natural person would be deemed to have disposed of the equity shares as trading stock to the extent of the R200 initial gross value of the shares (meaning that the net ordinary revenue is R100 after taking into account the deemed cost price of R100). However, the total gain attributable to the trading stock and the allowance assets is only an aggregate of R4.

Note: There is also some confusion about the deeming of trading stock in terms of the section 11(a) offset. We are assuming that the trading stock receipts of R200 comes attendant with a corresponding cost price deduction of the R100. If not, the taxpayer has R200 of ordinary revenue without any offset (effective gross-basis taxation).

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1.2 Inequities resulting from section 42(5) in respect of "loss" shares

The wording also triggers ordinary losses even though the rule was designed solely as an anti-avoidance measure to prevent the artificial conversion of ordinary gains into capital gains. The problem again relates to how the trading stock characterisation comes into being.

Example

Facts: The facts are the same as above except that the shares are sold for R60 instead of R270.

Result: In this scenario, the full R60 is deemed to be trading stock (with a cost price of R100). The net result is an unintended R40 loss.

Note: There is again some confusion about the deeming of trading stock. We are assuming that the trading stock receipts of R60 comes attendant with a corresponding cost price deduction of the R100. If not, the taxpayer has R60 of ordinary revenue without any offset.

Proposed recommendation

It is submitted that section 42(5) makes little sense under the current formulation. The rule should deem any capital gain arising from the disposal of the share as ordinary revenue. However, this gain should be limited to the extent that ordinary portion does not exceed the potential ordinary gain associated with the underlying assets that existed on the date of the initial section 42 transaction (i.e. does not exceed the ordinary revenue (including recoupments) that would have resulted had all the assets been sold for cash on the section 42 date).

1.3 IMPACT OF SECTION 42(5) IN THE CASE OF SUCCESSIVE SECTION 42 TRANSACTIONS

Problem statement

Section 42(5) indirectly makes successive share-for-share transactions prohibitively expensive if the company involved has ordinary assets exceeding 50 per cent of the total. The net effect is to trigger ordinary revenue for the second section 42 transaction where rollover relief would otherwise prevail.

We fail to see the reason why successive section 42 transactions are prohibited when section 42 transactions can be followed by other rollover reorganisations (e.g. section 46 and 47). In fact, a successive section 42 transaction creates less of a concern in terms of an artificial capital-to-ordinary revenue scheme because the second section 42 transaction is subject to the same section 42(5) anti-avoidance rule (with an extended 18 month date).

This prohibition is a concern because a successive section 42 transaction can be a useful rollover device in terms of larger share-for-share transactions, especially where listed or public companies are involved. For instance, assume an Acquiring Company is a listed holding company with several chains of subsidiaries. Assume also that Acquiring Company wants to acquire the shares of a Target Company but indirectly holds that Target Company through a wholly owned subsidiary. Under these circumstances, a successive section 42 would allow Acquiring to acquire the Target with Acquiring shares, followed by a redeployment of the Target shares to lower-tier subsidiaries. We further note that section 42 duplicates the gain so successive section 42 transactions simply create successive layers of the same gain. Therefore, we fail to see the risk of successive section 42 transactions given this gain duplication.

Proposed recommendation

It is submitted that section 42(5) should contain a carve-out for asset-for-share transactions. Stated in drafting terms, section 42 should be added to the carve-out list contained in the parenthetical.

2. SHARE DISTRIBUTIONS V SHARE ISSUES - SECTION 40C

Problem statement

Section 40C essentially deals with capitalization issues. Section 40C(a) refers to the distribution by a company of a share in that company. Section 40C(b) refers to an issue of shares in that company for no consideration. The recipient of the shares in both scenarios is deemed to have incurred expenditure of Rnil in relation to the shares so received.

In terms of South African company law, a company cannot hold its own shares as treasury shares as it is obliged to cancel the shares after the repurchase. It is therefore submitted that section 40C(a) is redundant and that section 40C(b) would cover all capitalization issues sufficiently.

The more relevant issue in relation to a capitalization issue is how the receipt of the shares must be treated in the hands of the shareholder. As soon as the capitalization issue is approved by the board, the shareholders of that specific class obtain a real right to the capitalization shares. This real right would then be viewed as technically disposed of by the shareholder on issue of the capitalization shares in exchange for the capitalization shares. This "technical" disposal then creates a capital gain or loss that potentially leads to double taxation when the capitalisation share is ultimately disposed of by the shareholder. It is a well-established principle that Income Tax should not be levied twice on profits received only once, unless the language of the Act makes it clear that such a result was intended (see *Isaacs v CIR* 1949 (4) SA 561 (A), 16 SATC 258 at 266).

Furthermore, when one considers the effect of section 40C that deems the capitalization share to have been acquired at a cost of Rnil together with the Isaacs case above, it becomes apparent that the disposal of the real right in exchange for the share must be disregarded. Under the normal barter rules (without considering section 40C), the shareholder would be deemed to have acquired the capitalization shares at a cost equal to the market value of the asset (the real right) disposed of in exchange for the capitalization share. This position is, however, modified by section 40C as stated above.

Our line of thinking is similar to that expressed in para 6.1.3.14 of the *SARS Draft Comprehensive Guide to Capital Gains Tax (Issue 5).*

Proposed solution/Recommendation

It is proposed that section 40C(a) be deleted. It is further proposed to exclude from the definition of "gross income"/"proceeds" any amount arising from an exchange of rights where the shareholder receives shares in a company where the tax value or base cost of the shares so received is subject to a deemed Rnil consideration value as contemplated in section 40C.

3. SECTION 9C AND RETURN OF CAPITAL DISTRIBUTIONS

Problem statement

The purpose of section 9C is to treat the gain or loss arising from a share as capital as opposed to ordinary revenue given the long-time frame involved (in effect creating a deemed "investment purpose" under case law). In more literal terms, the section 9C definition of "qualifying share" has the effect that section 9C(2) (i.e. capital treatment) applies to all amounts other than dividends or foreign dividends received after disposal of the qualifying share. At issue is the "disposal" trigger mechanism required for the application of section 9C and the impact of this trigger when return of capital distributions are involved.

The main problem associated with return of capital distributions is the fact that the law does not treat these distributions as a "disposal". The main act is silent on the matter. In terms of the Eighth Schedule, a return of capital distribution either reduces base cost or triggers capital gain in respect of shares qualifying as capital (paragraph 76B of the Eighth Schedule). The mere holding of a share for a three-year period is insufficient for section 9C to apply to capital distributions because the distribution itself is not viewed as a disposal.

It is submitted that there is no basis to treat the above return of capital differently than other forms of gain. Indeed, the initial version of capital distribution under paragraph 76A contained part-disposal treatment. The new system was designed to align with international standards and avoid certain technical anomalies associated with the old part-disposal treatment. The new system was

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not designed to leave return of capital distributions at a disadvantage vis-à-vis other Eighth Schedule events in the case of the three-year rule under section 9C.

Proposed solution/recommendation

It is submitted that the definition of "qualifying share" in section 9C(1) should be amended to include any "return of capital" received in respect of the share once the share is held for a continuous period of at least three years. At a technical level, the simplest solution is to treat a return of capital distribution as a "disposal" for section 9C purposes.

4. THIRD-PARTY BACKED SCHEMES

We would suggest that the relief for equity shareholders of a special purpose company issuer of preference shares contemplated in section 8EA(3)(b)(vii) be more closely linked to the qualifying purpose definition. These companies are preference share funding companies for BEE groups to acquire operational target companies and are used by financial funders, especially the IDC. In these case, enforcement rights or enforcement obligations should be allowed against any issuer of preference shares utilised for al qualifying purposes: (i) to acquire an equity share in an operating company (see paragraph (a) of the qualifying purpose definition), (ii) to acquire or redeem previously qualifying preference shares (see paragraph (c) of the qualifying purpose definition), or (iii) to pay domestic or foreign dividends in respect of qualifying preference shares (see paragraph (d) of the qualifying purpose definition).

We see no policy reason that this group of shareholders be limited to a single "qualifying purpose" (i.e. the initial acquisition of operating equity shares). This limitation contradicts the remainder of section 8EA, which recognises the full funding cycle (including the importance of re-financing). SPVs are an important part of the preference share funding process, especially where groups of smaller investors are involved (including broad-based BEE).

5. DIVIDENDS VERSUS SERVICES (PROVISO (ii) TO SECTION 10(1)(K)(i))

5.1 One–person companies

Background

Many small businesses are run by a single person. In the case of small businesses operating in the form of a company, the sole owner is the sole shareholder.

In these circumstances, the line between sole shareholder and key employee becomes blurred because that person earns a return from the involvement in this business for time spent and for entrepreneurial efforts / risks taken. Given that a single shareholder / key employee acts in both capacities, any service versus dividend allocation is likely to have a high degree of subjectivity. Newly enacted proviso (ii) to section 10(1)(k)(i) potentially places the dividends received by sole shareholders / key employees at continual risk of challenge. A critical issue for many small businesses.

It should be noted that the overall difference in aggregate tax in respect of key employee services and dividends is fairly small. In the case of a natural person, the highest rate is 41 per cent versus dividends, the latter of which are effectively taxed at 38,8 per cent (once the 28 per cent company tax is taken into account). In fact, many taxpayers of lesser means would prefer service income because the effective rate for them is likely to be less than 41 per cent (meaning that that proviso (ii) to section 10(1)(k)(ii) will result in lower taxes collected by the *fiscus*).

Our problem is the potential penalty implications of a re-allocation under proviso (ii) to section 10(1)(k)(ii). While the overall differences above are not material, a re-allocation will trigger penalties and interest in respect of foregone PAYE (see section 11C of the Fourth Schedule). More importantly, if proviso (ii) to section 10(1)(k)(i) is applied to trigger a re-allocation from dividends to services, the re-allocation occurs only at the shareholder level without creating a corresponding deduction for the deemed service payment. The net effective tax rate could then exceed 60 per cent (28 per cent in the company and 41 per cent in his own hands on the distribution).

Whilst one could argue that larger players in the market potentially have the compliance team to avoid the above re-allocation, smaller companies will easily be caught by surprise. The net result could be a significant tax liability for an inadvertent error that could trigger a serious unexpected tax cost for smaller companies.

<u>Proposed solution/recommendation</u>

We would therefore suggest an exclusion from the proviso for mid-sized and smaller businesses. This exclusion could apply for companies with a book value of R50 million or less (see section 12J(6A)).

Proposed wording:

"There shall be exempt from normal tax—…

> (k) dividends (other than dividends paid or declared by a headquarter company) received by or accrued to any person: Provided that this exemption shall not apply—…
>
> (ii) to any dividend received by or accrued to a person in respect of services rendered or to be rendered or in respect of or by virtue of employment or the holding of any office, other than a dividend received or accrued in respect of a restricted equity instrument as defined in section 8C held by that person or in respect of a share held by that person: <u>Provided that</u>

<u>this subparagraph does not apply to amounts received by or accrued to a natural person from a company where that person holds all of the shares issued by the company, is the sole director of the company, and the company has a book value not exceeding R50 million at the beginning of the year of assessment</u>."

5.2 Indirect ownership in private companies through trusts

<u>Problem statement</u>

Employee (including BEE employee) groups often pool their resources via a trust to collectively acquire a percentage share interest in a company. In these circumstances, typically:

- The parties establish a trust with various beneficiaries (e.g. employees and BEE shareholders);
- The parties contribute cash to the trust in exchange for becoming vested beneficiaries (in relation to certain income);
- The trust applies the cash in acquiring shares in the company at market value;
- Note: There are no restrictions in relation to the holding of beneficial interests in the trust or the trust's holding of shares in the company (i.e. section 8C does not apply).

The commercial benefit of this arrangement is that only <u>one</u> party (i.e. the trust) becomes a party to a shareholders agreement for centralised shareholder-control (e.g. a major shareholder or a director could also be a trustee so there is some degree of oversight).

In this circumstance, the company pays dividends to all shareholders, including the vested trust beneficiaries. Because the trust solely has vested interests, proviso (ee) to section 10(1)(k)(i) does not apply. The issue instead relates to whether the dividend is taxable in the hands of the "employee beneficiaries" in terms of proviso (ii).

Factually, the "employee beneficiaries" acquired their right to participate in the scheme via an indirect ownership of shares by virtue of their employment/holding of office. Yet, the funding for the actual shares comes from their own resources (cash/debt), not as service compensation. In addition, the dividends are determined at the sole discretion of the directors (with the trust representing only part of the equation). Yet, there is a risk that the "in respect of" or "by virtue of" language can trigger ordinary treatment under proviso (ii).

<u>Proposed solution/Recommendation</u>

The direct or indirect linkage to dividends via the share needs to be clarified. Presumably, it is the actual receipt of the dividends as direct or indirect compensation for services is the issue. If shares are purchased at full market value with independent resources, dividends should never fall into proviso (ii). Mere employment within the company should not be sufficient as a trigger. We would accordingly request clarification by way of legislation or via a SARS class binding ruling.