national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

MEDIA STATEMENT

Taxation Laws Amendment Bills, 2008: Company Restructuring Measures

21 February 2008

This media statement is being released along with the general media release that provides a brief overview of the Taxation Laws Amendment Bills, 2008. The purpose of this release is to highlight certain matters relating to company restructurings that require attention. The first portion of this media release describes the legislative remedy for certain uncertainties in respect of intra-group rollover relief arising from the Revenue Laws Amendment Act, 2007. These changes further close loopholes in respect of this relief. The second portion of this media release describes the closure of loopholes relating to cross-border exemptions.

I. Misuse of intra-group rollover relief

1. Background

In 2007, the section 41 definition of a group of companies qualifying for rollover relief (and group debt cancellation relief) was narrowed. All companies within a group not only had to be a single economic entity (akin to divisions of a single company), but these companies further had to operate under the same tax playing-field from both a policy and administrative tax perspective. As a consequence, only companies subject to comprehensive tax on worldwide income would remain within the group definition. The net effect of these changes, amongst others, was to remove all foreign incorporated companies from the section 41 group definition. This change was set to become effective as of 1 January 2009.

2. Foreign companies

a. Rationale for the 2007 exclusion restated

Some commentators contended that no rationale existed for the exclusion of foreign incorporated companies as long as intra-group relief was limited to transfers between fully taxable companies. The exclusion was also said to improperly limit foreign investment to a single entry point. It was argued that South African brother-sister companies should remain part of the same group even though these companies were linked solely through a common foreign parent company.

Both underlying company assets and shareholdings must be completely within the South African tax net in order to protect the tax base. Evidence already exists that the previous failure to have group shareholdings fully within the tax net created tax avoidance opportunities. In one set of schemes, taxpayers used these foreign controlled brother-sister groups to convert fully taxable profits under the Secondary Tax on Companies) into capital gains free from tax by virtue of the foreign shareholding. These dangers can best be illustrated through the following example. [In addition, underlying capital gains could also be wrongfully compromised.]

Example: Facts.
Foreign Parent owns all the shares of Operating Subsidiary (a South African company) with a R800 000 base cost. Operating Subsidiary owns business assets with a value of R1 million and a base cost of R200 000, and Operating Subsidiary has R200 000 of share capital and R800 000 of profits. The group enters into the following transaction to shift all Operating Subsidiary assets under direct Foreign Parent control.

Step 1: Foreign Parent forms Newco Subsidiary (another South African company) with nominal consideration.
Step 2: Operating Subsidiary transfers all of its assets to Newco Subsidiary in exchange for a Newco Subsidiary note of R1 million (guaranteed by Foreign Parent).
Step 3: Newco Sub distributes all the recently received business assets to Foreign Parent.

Result.
Prior to the Revenue Laws Amendment Act, 2007, Foreign Parent, Operating Subsidiary and Newco Subsidiary were all part of the same group. As a result,

In Step 2: If an election was made, the transfer from Operating Subsidiary to Newco Subsidiary was a tax-free section 45 rollover with the R200 000 base cost of the business assets rolling over to Newco Subsidiary.

In Step 3: Because Newco Subsidiary has no profits, the subsequent distribution is viewed as a capital distribution (which is free from the Secondary tax on Companies). Moreover, because Foreign Parent is a non-resident, any capital gains resulting from the capital distribution in respect of the Newco Subsidiary shares similarly went untaxed. The only tax remaining was the underlying gain on the business assets.

The net effect, barring the application of the general anti-avoidance rule, is to eliminate one level of tax. With a little more planning, it may even be possible to transfer the Operating Subsidiary shares to Newco Subsidiary (i.e. assets with a high base cost and low market value) to trigger an artificial loss for Newco Subsidiary as a means to offset the gain on the business assets transferred. However, upon implementation of the change to the group definition, the benefits of this scheme are effectively terminated. Operating Subsidiary and Newco Subsidiary will no longer be part of the same group, thereby eliminating the tax-free rollovers used to initiate this transaction.

b. Foreign companies treated as South African tax residents

One related issue is the exclusion, from a group of companies, of foreign incorporated companies that are effectively managed within South Africa. While these companies were fully subject to the South African tax, concerns existed about administrative enforcement (and the ease with which these companies could re-shift their tax residence abroad).

After further consideration, this exclusion will be removed. These entities do not give rise to the tax avoidance difficulties as outlined above because they are fully within the tax net. Moreover, failure to include these entities may be problematic in terms of tax treaty anti-discrimination provisions, and these entities may even offer non-tax practical advantages when foreign investors seek to invest in South Africa. Foreign companies with South African tax residence are fully within enforcement reach as long as these companies have registered as external companies under the Companies Act (1973). Re-inclusion of these foreign companies will be effective when the new section 41 group definition goes into effect.

3. Immediate closure of ongoing tax avoidance schemes

The main problem with the section 45 rollover regime is the asymmetry this section causes between the assets transferred and the consideration received in exchange. Group assets transferred retain a rollover tax cost, but consideration received in exchange obtains a market value tax cost. This asymmetry has been used by certain taxpayers to artificially cash-out subsidiary operations wholly free from tax. Section 45 rollover relief was never intended to apply in respect of this cashing-out; it was merely intended to allow for the deferral of gain/loss when assets are moved within a single group. This cashing-out can best be illustrated through the following example.

Example: Facts.
Parent owns all of Operating Sub. Operating Sub has assets with a value of R1 million and a base cost of R200 000. Parent plans to sell Operating Sub to Independent Purchaser. In order to effect these goals, the parties enter into the following transactions:

Step 1: Parent forms Newco Sub for nominal consideration.
Step 2: Operating Sub transfers all of its assets to Newco Sub in exchange for a R1 million note issued by Newco Sub (and guaranteed by Parent).
Step 3: Operating Sub distributes the R1 million note to Parent as a dividend, leaving Operating Sub as an empty shell.
Step 4: Parent transfers all the shares of Operating Sub to Newco Sub in exchange for the issue of additional Newco Sub shares.
Step 5: Independent Purchaser pays R1 million for the note and nominal consideration for all the shares of Newco Sub (which in turn owns all of Operating Sub).

Result.
Parent, Operating Subsidiary and Newco Subsidiary are all part of the same group. As a result,

In Step 2: The transfer from Operating Subsidiary to Newco Subsidiary is currently a tax-free section 45 rollover with the R200 000 base cost of the business assets rolling over to Newco Subsidiary.

In Step 3: The dividend distribution by Operating Sub of the Note to Parent is free from the Secondary Tax on Companies under section 64B(5)(f) by virtue of the group relief election (no capital gains tax arises because the note has a base cost equal to its R1 million market value).

In Step 4: The transfer of the Operating Sub shares by Parent to Newco Sub will not generate any gain (and may even trigger a clogged loss) because Operating Sub is now an empty shell.

In Step 5: The sale of the R1 million note and the Newco Sub shares generates little or no tax. The R1 million note has a R1 million base cost, which is equal to the note's market value. Due to its indebtedness by virtue of the note, the Operating Sub shares have little or no net value that can be taxed.

Although the above transaction is susceptible to the general anti-avoidance rule, this transaction illustrates the unintended impact of the asymmetry. The market value tax cost of the intra-group note issued allows for an untaxed sale of a subsidiary to outside group members. In other transactions, the parent company borrows cash proceeds from the purchaser (or from an independent bank backed by an anticipated purchase), and this cash is run through the group tax-free via the intra-group relief provisions. The net effect is to bump-up the base cost of the operating subsidiary, thereby removing the gain from tax upon sale.

In order to eliminate this asymmetry, intra-group relief under section 45 will be modified. The tax cost of intra-group notes issued in a section 45 transaction will now be limited to the lesser of the tax cost of assets transferred or the market value of the note issued. This change will mean that the R1 million note issued in the example will be limited to R200 000 so the sale of the note will trigger an R800 000 gain. In order to eliminate similar forms of avoidance (i.e. the use of cash-loan proceeds), intra-group relief will be limited to two forms of transfer – the transfer of intra-group assets in exchange for a note issued by the transferee (as discussed in the first example) or for no consideration, such as an intra-group distribution of assets from one group company to another.

These changes should eliminate the avoidance of concern without undermining the effectiveness of the relief for intra-group transactions. Most commercial intra-group transactions involve either the transfer of intra-group notes at cost or a straight distribution of assets from one company to another. In addition, taxpayers can continue to transfer assets in exchange for shares as an indirect method of intra-group transfer (via the “asset-for-share” rollover provisions). Due to changes made in 2007, this form of indirect intra-group transfer effectively means that the shares issued will have a tax cost limited to the lesser of the tax cost of the assets transferred in the case of transferred built-in gain assets or market value in the case of built-in loss assets (loosely resembling the proposal for intra-group notes).

4. <u>2007 legislative de-grouping charge</u>

One of the most discussed aspects relating to the 2007 intra-group legislative changes was the impact of changing the group definition in respect of current groups. As discussed at the beginning of this media statement, the company group definition fully excludes entities partially or fully outside the tax net. For instance, two South African companies owned by a single foreign parent company will no longer qualify as part of the same group due to the legislative change.

The practical impact of this change is to trigger a de-grouping charge for companies previously engaged in an intra-group transfer. The 2007 legislative change sought to mitigate the de-grouping charge caused by this legislation by delaying the effective date of the change until 2009. This delay was enacted to provide taxpayers with an opportunity to re-group by restructuring their affairs. Commentators contended that this aspect of the proposal was unfair. First, taxpayers arguably should not be subject to the de-grouping charge merely because of a legislative change (as opposed to future taxpayer action). Second the proposed delay for restructuring is impractical because many legitimate transactions are subject to long-term contracts that prevent this form of restructuring.

In view of the above concerns, it is proposed that complete relief be given to all groups separated by the legislatively revised group definition. In other words, any tax caused by this form of de-grouping will be disregarded. Relief is granted in these circumstances because the transactions outlined above illustrate how taxpayers have managed to cash-out without separating the buying and selling companies. Hence, a legislatively imposed de-grouping charge won’t trigger a de-grouping charge for the avoidance transactions of concern while impacting legitimate transactions trapped in restrictive contracts that prevent restructuring. Given this complete relief, it is proposed that the narrowed group definition become effective with effect from the date of this media release (as opposed to the delayed 1 January 2009 effective date).

II. Misuse of cross-border exemptions

1. Capital gains exemption for domestic shares disposed of by foreign taxpayers

In accordance with widespread international practice, foreign taxpayers are not subject to any capital gain charges when selling domestic shares. This practice is often enshrined by tax treaty. Of concern is the fact that foreign shareholders may use this exemption to bump-up the base cost of all shares at every level of a controlled group. This transaction can best be illustrated as outlined below.

Example. Facts.
Foreign Parent owns all the shares of a South African group of companies headed by Oldco Holding Company. Oldco Holding Company owns all the shares of five Operating Subsidiaries. The Holding Company has a market value of R10 million and a base cost of R1 million. In order to bump-up the base cost of all the subsidiaries to market value without tax, the overall structure is reorganised as described.

Step 1: Foreign Parent forms a Newco Holding by paying R10 million to Newco Holding in exchange for the newly created Newco Holding shares.
Step 2: Newco Holding uses the R10 million to acquire Oldco Holding Company from Foreign Parent.
Step 3: Oldco Holding Company unbundles all of the Operating Subsidiaries to Newco Holding.

Result.
The overall transaction allows for the base of all the Operating Subsidiaries to be bumped-up to market value without tax (thereby being capable of sale to outsiders without any remaining taxable gain).

In Step 1: The base cost of Newco Holding is irrelevant because Foreign Parent can sell these shares tax-free regardless of the gain involved due to the foreign ownership.
In Step 2: The sale to Newco Holding is tax-free (again because the sale is made by Foreign Parent
In Step 3: The new R10 million base cost is spread among the Operating Subsidiaries according to their market value by virtue of the tax-free unbundling provisions of section 46.

The problem illustrates how a single exemption available to a foreign parent company can be artificially shifted to all lower-tier domestic-level shareholdings. In order to remedy this unintended advantage over domestic groups, proposed legislation will be enacted to prevent this practice. Under this legislation, Newco Holding will have its base cost limited to the base cost previously held by Foreign Parent before the intervening sale. It is proposed that this amendment become effective with effect from the date of this media release.

2. Capital gains exemption for foreign shares disposed of by domestic taxpayers]

The Income Tax Act contains special rules designed to facilitate the repatriation of foreign-derived proceeds back to South Africa. Section 10(1)(*k*)(ii)(*dd*) allows for the tax-free repatriation of dividends from foreign shares of at least 20-per cent owned foreign companies. Paragraph 64B of the Eighth Schedule contains a related exemption for the disposal of similarly owned foreign shares. Paragraph 64B has twin aims. Paragraph 64B eases the conversion of foreign subsidiary operations to cash for repatriation back to South Africa, and paragraph 64B eases the restructuring foreign subsidiaries remaining under South African control.

Despite the purposes outlined above, paragraph 64B has been subject to misuse. The very exemption designed to repatriate funds back to South Africa (or to restructure foreign subsidiaries while remaining under South African control) is being used to undermine the South African tax base. In transactions of this kind, paragraph 64B is used to shift South African owned foreign subsidiaries outside the South African tax stem, thereby limiting South Africa's global tax reach. This removal was never the intention; and while rules have been enacted to prevent this misuse via paragraph 64B(3), this misuse remains an ongoing concern. Given these concerns, a case could be made for the repeal of paragraph 64B in view of this misuse, especially in light of the easing of Exchange Control.

At this stage, time-constraints demand that immediate change in this area should be limited solely to remedying targeted concerns until space exists for a more comprehensive review. The Taxation Laws Amendment Bills, 2008 accordingly address some of these more pressing issues. Any legislative amendments are proposed to be effective from the date of this media release.

III. Public comments and parliamentary hearings

The National Treasury is scheduled to brief the Parliament's Portfolio Committee on Finance on the draft legislation on 4 March 2007. Parliament will request public comments on the draft Bill, and thereafter hold public hearings later in the month. Whilst all comments should be submitted to the Parliamentary Portfolio Committee of Finance, members of the public are also invited to send the same comments to the National Treasury and South African Revenue Service directly.

National Treasury and SARS will consider all comments submitted as well as any recommendations arising from the Parliamentary hearings, when finalising the proposed legislation for tabling in Parliament in late March 2007. Comments should be sent to National Treasury by email to jeanne.viljoen@treasury.gov.za or by fax to 012 315 5516. Please ensure that the comments reach us by 5 March 2008.