national treasury
Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

MEDIA STATEMENT

Avoidance Closure Alert: Funnel Financing Masquerades

20 March 2008

I. Background

This media statement is the product of information uncovered during the consultation process associated with the recently introduced Taxation Laws Amendment Bills, 2008. One of the main issues addressed is the closure of avoidance involving section 45 rollover relief. More specifically, intra-group rollover relief had inadvertently become a means of obtaining tax-free sales to independent parties, and the Bills are designed to close this practice.

However, it soon became apparent that certain section 45 transactions were additionally acting as a masquerade for funnel financing schemes. Whilst these latter schemes are fewer in number, the tax sums involved are far greater (amounting to hundreds of millions over the financing cycle). The purpose of this media statement is to urgently address funnel financing schemes with probable tax legislation to follow during the second half of the year.

II. Nature of the scheme

A. Funnel financing without the masquerade

Funnel financing comes in a variety of forms. In the schemes thus far uncovered, certain common characteristics emerge. First and foremost, these schemes involve a circular flow of funds from a lending bank (or other financier) through a borrowing group of companies, followed by the re-routing of these funds back to the lender. This cycling of funds through the group is facilitated by a tax-deferred intra-group sale of an operating business via section 45. In terms of tax objectives, the circular flow of funds is designed to create tax deductions on the one end with a tax-exempt (or tax indifferent) party shielding income on the other.

In one set of schemes, the objective is to generate tax deductions for lenders without any corresponding economic outlay. This result is achieved by having the lender funnel funds through the borrower in the form of a loan with the borrower using the loan proceeds at the lender's behest. This use of loan proceeds essentially involves the return of the

funds to the lender as a deposit, thereby generating deductible interest for the lender in respect of the deposit. The alleged loan is later unwound tax-free (or may even generate a further tax loss).

In a second set of schemes, funnel financing can alternatively be used to generate artificial deductions for the borrower (as opposed to the lender). This result is achieved by having the lender funnel funds through the borrower in the form of a loan with the borrower again using the loan proceeds at the lender's behest. At the end of the day, one part of the group receives annual tax-exempt income while the other part pays annual deductible interest. The lender enters into various schemes in order to avoid tax on the annual interest received.

B. The masquerade

Even the most aggressive tax planners seemingly recognise that these artifices cannot be legitimised under current law if created in isolation. However, a minority of tax planners take the position that these funnel financing schemes can be maintained if placed behind an otherwise commercial façade. It is understood that broad-based economic empowerment has become the latest fashion in this façade. However, it is understood that broad-based economic empowerment transactions are by no means alone in this regard nor are these transactions always used in this illegitimate way.

In the deals of concern, a pre-existing group creates a newly formed company with broad-based economic empowerment partners. The pre-existing group controls 70 per cent of the newly formed company with the broad-based empowerment partners owning the remaining 30 per cent. The pre-existing group then transfers all the assets of an operating business to the newly formed company in exchange for debt, leaving the newly formed company with little net value. The broad-based empowerment partners are economically left only with future appreciation rights. Little external funding is accordingly required, but large amounts of external funding is still used so that the lender has a pretext for the funnel masquerade outlined above.

The amount funnelled is often equal to the value of the total business assets transferred to the newly formed company. Section 45 plays a key role in allowing for a tax-free transfer. This tax-free transfer in value from one group company to another creates the pretext for the debt proceeds to be cycled through the borrowing group.

III. Proposed solutions

A. Current paradigm

At the outside, the funnel financing masquerade is highly questionable under current law notwithstanding any practitioner opinions to the contrary. First and foremost, the funnel financing masquerade is a direct violation of the General Anti-Avoidance Rule on multiple levels (see Part IIA (i.e. sections 80A through 80L) of the Income Tax Act). In the very least, the transactions at issue fall squarely within the round-tripping paradigm. The fact that the funnel is attached to an otherwise commercial transaction fails to alter the overall analysis, even if that otherwise commercial transaction relates to broad-based empowerment. Offending steps or parts of a connected series of transactions cannot be saved merely because they are part of a legitimate whole (see section 80C(2) of the Income Tax Act). Arguments that the cycling of funds can somehow be formally separated in the analysis (via the section 45 transfer or otherwise) lack any bearing to reality. It should also be noted that judicial doctrines would suggest that funnel financing is likely to be disregarded as a simulation.

The questionable nature of the funnel financing masquerade additionally raises some troubling questions about the larger role of certain aggressive tax advisors in terms of a sustainable tax system. Technical arguments must bear some resemblance to underlying facts and must reflect some degree of rationality. Consideration must be given toward holding aggressive tax advisors to account when their opinions are based almost exclusively on wishful thinking in the pursuit of lucrative fees.

B. Audit consideration

The superficial nature of the funnel financing structure has a border-line evasive element. Legal opinions in this context effectively provide an "air" of legitimacy to a series of artificial steps cloaked behind broad-based empowerment or other commercially legitimate transactions. This cloak is often protected by multiple layers, all of which are designed to complicate and disguise the audit trail. In effect, the parties are playing a game of audit lottery backed by a purchased legal opinion. The fact that the parties at issue are joined by other parties in the market-place undertaking the same scheme is simply a gambit to find safety in numbers.

In order to counter this factual cloak, consideration will be given toward invoking a higher level of reporting for transactions of this kind. One option would be to invoke the reportable arrangements regime (Part IIB (section 80M through 80T) of the Income Tax Act. Another option would be to rely on the Commissioner's newly created reporting powers under section 41 to root out artifices attendant with reorganisations. Further consideration may have to be given toward tightening the section 45 regime by requiring Commissioner pre-approval under specified circumstances so that taxpayers will bear the burden of revealing the full array of facts before obtaining the benefits of section 45 tax deferral.

C. Proposed legislation

Given the above, it can be questioned whether further legislation is necessary, but experience suggests that certain practices cannot easily be deterred in the market-place other than by targeted anti-avoidance rules. Aggressive taxpayers seemingly take pause only if faced with a direct objective prohibition. Therefore, legislation of this kind needs to be considered, especially given the variety of forms in which these funnel financing schemes arise.

Some options under consideration are as follows:

1) Interest deductions could be denied for borrowed capital deposited with a lender if the underlying capital otherwise giving rise to those tax deductions stems from funds directly or indirectly supplied from the lender (or from a related group of companies);

2) Interest deductions could be denied for borrowed capital to the extent those funds are invested by the borrower (or by a related group of companies) in a tax-exempt investment vehicle;

3) Preference shares acting as the main direct or indirect object of a limited recourse loan could be deemed to generate taxable interest (instead of tax-free dividends), and all gains would be ordinary revenue (with all losses being denied); and/or

4) Section 45 rollover relief could be denied if section 45 proceeds must be applied to a tax-free investment at an outside lender's behest.

All targeted anti-avoidance legislation will be effective as from the date of this media statement. Therefore, any denial of interest deductions would be effective from this date forward even if the underlying loans were initiated at a prior date. Little sympathy exists for a delayed effective date on these matters given the highly questionable nature of the funnel financing masquerade under current law.

IV. Public comments and parliamentary hearings

In order to obtain prompt resolution of these matters in preparation of the upcoming Revenue Laws Amendment Bills, 2008, National Treasury and the South African Revenue Service invite public comment on how to address the funnel financing masquerade. The weight given to these comments will strongly depend on the detailed level of commercial facts concerning the transactions involved. Legal and economic arguments based on vague factual assertions will be given little weight. Comments should be sent to Jeanne Viljoen by email at jeanne.viljoen@treasury.gov.za or by fax to 012 315 5516. Please ensure that these comments are transmitted by 30 April 2008.