national treasury

Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

MEDIA STATEMENT

Taxation Laws Amendment Bills, 2009: Funnel Finance Schemes

I. Background

This Media Statement is being issued by the National Treasury as a supplement to the Media Statement issued on 20 March 2008 titled "Avoidance Closure Alert: Funnel Financing Masquerades" ("the previous Media Statement"). The previous Media Statement expressed concerns relating to certain avoidance schemes that employ funnel financing in the context of section 45 of the Income Tax Act.

II. Nature of the Scheme

A. Original Understanding

Generally, funnel financing involves the circular flow of funds from a lender (i.e. a bank or other financial institution) through a borrowing group of companies that lead back to the lender. This circular flow of funds is designed to create a tax benefit for the lender on one end with a tax-exempt (or tax-indifferent) party shielding income from taxation on the other.

As discussed in the previous Media Statement, the schemes at issue require a circular flow of funds through a borrowing group offering a business pretext for the lending. This pretext is needed so as to arguably shield the overall arrangement from arguments that the circular flow of funds violate the general anti-avoidance rules, are synthetic or are otherwise a sham. The most easily used pretexts are black economic empowerment financing and securitisation transactions. Both sets of pretexts require an intra-group sale of assets within the borrowing group, and this intra-group sale is accomplished without negative tax consequence via the tax-deferral rules of section 45. The assets involved in the sale have substantial value, often being an entire operating business.

Although multiple steps are invariably involved, funnel financing schemes frequently have the following steps in common:

Step 1: In order to transfer an operating business, a pre-existing group forms a company (in which a third party has an interest) to which the operating business is sold by way of an intra-group transaction. The transaction is structured so that all of the requirements of section 45 are met, thereby deferring all potential gain on the transfer of the operating business. In the case of a black economic empowerment transaction, the black economic empowerment partners typically own up to 30 per cent of the shares in the newly formed company.

Step 2: In order to allegedly fund the purchase of the operating business, the newly formed company obtains a loan from a lender external to the group. The alleged need for external borrowing is a critical pretext to set the lending institution's involvement into motion.

Step 3: It is a condition of the loan that the proceeds from the intra-group sale of assets (purchased with the loan funds) will be reinvested in accordance with the instructions of the lender. In these instructions, the lender typically requires the borrowing group to invest the proceeds in various highly secured instruments that yield passive returns. These passive returns almost universally generate tax advantaged receipts or accruals for the group. Tax-free preference shares are the most commonly-employed instruments utilised.

Step 4: The passive instrument utilised in Step 3 (e.g. the preference shares) are typically issued by a party with some form of connection to the lending institution. The funds received in exchange for the issue are then routed back to the lender so as to generate tax benefits (e.g. deductions) for the lending institution as if held on deposit.

It should be noted that the yield from the secured instruments held by the borrowing group often exceeds the yield generated by the lender in respect of the underlying loan. Given the passive nature of the secured investments, this higher yield makes little sense for the lender unless the lender is receiving some other form of compensation (e.g. tax benefits).

B. <u>Further Analysis</u>

Subsequent to the release of the previous Media Statement, the National Treasury consulted widely on the issue of funnel financing. While a fair amount of information was available in respect of the borrowing group, little information was forthcoming in respect of the lending institution's involvement.

Based on further information obtained in the interim, it appears that many of these schemes seek to artificially shift income outside South African taxing jurisdiction or to artificially obtain access to foreign tax credits for the benefit of the lending institution. These tax benefits are typically obtained via the incorrect use of tax treaties in relation to income that is effectively derived from a South African economic activity. Reliance is for example, placed on the artificial categorisation of entities under the law of other States without taking cognisance of the role of domestic law when applying the relevant tax treaty. Other approaches also rely on an interpretation of tax treaties which ignores the normal rules to be applied in this regard, e.g., the importance to be accorded to a specific provision's context when interpreting and applying it.

At this stage, two primary methods appear to exist by which these tax benefits are generated:

Method 1: *Split Incorporation/Effective Management:* In one set of schemes, the lending group employs a company with split incorporation/effective management. More specifically, the company at issue is incorporated within South Africa but is effectively managed in a foreign tax haven treaty country. Under the tie-breaker clause of the applicable treaty, tax resident status lies in the foreign tax haven country due to the foreign effective management. This foreign tax residence status gives the entity to the desired shift of income outside South African taxing jurisdiction. However, this approach raises the issue of substance over form when making the determination of the place of effective management.

Method 2: *Hybrid Tax Entities:* In the second set of schemes, the lending group employs a limited partnership with South African partners (and potentially foreign partners). The limited partnership at issue is not a juristic entity for South African tax law purposes. However, the limited partnership is structured in order to be viewed as a company for foreign tax law purposes of the applicable tax treaty country. It is argued that this split status gives the parties at issue the best of both worlds – treaty access to foreign tax credits while allegedly avoiding the need for Exchange Control approval from the South African Reserve Bank. The categorisation of this partnership under foreign tax law appears to ignore, however, the rights of the State which is applying the provisions of the tax treaty.

III. Proposed Remedies

Aside from targeted enforcement, an immediate two-part remedy is proposed to counter the avoidance caused by funnel financing schemes. Potential legislation also remains under consideration.

A. Proposed Tax Treaty Renegotiation/Exchange Control Approval

Subject to source rules in any tax treaty, foreign tax credits should not be available for income that has its economic source within South Africa. The tax treaty rules for determining residency that are based on effective management may also require reconsideration, particularly in the light of the current debate in this regard in international fora.

Because foreign tax treaty renegotiations may be time-consuming, it is proposed that with effect from 2009-03-01, all Exchange Control applications to be submitted by Authorised Dealers on behalf of South African registered entities to the Exchange Control Department of the South African Reserve Bank should reflect the tax resident status of such South African entities. Exchange Control Department shall identify all South African entities with tax residence elsewhere, other than South Africa and the information on these entities will in future be shared with SARS. Relaxation of this aspect of Exchange Control policy will only be reconsidered after the tax treaties of concern are renegotiated so as to effectively counter the tax avoidance caused by the funnel schemes described herein.

B. Potential Legislation

Future legislation remains under consideration depending upon further facts uncovered. One solution under active consideration is potential legislation that targets the investment of section 45 proceeds into otherwise tax-exempt preference shares. The financial lack of risk associated with these preference shares makes it questionable whether the preference share dividends are in fact economically equivalent to dividends or interest. Under this line of reasoning, dividends from preference shares stemming from dedicated section 45 transactions should be treated as taxable interest. This legislative proposal would apply to all preference share payments arising after 20 March 2008. This proposal would be associated with the deemed interest rules existing under section 8E.

IV. Public comments

The National Treasury requests public comments on this media statement before technical documents are released in support of the decisions announced herein. Comments should be sent to Yanga Mputa by email at yanga.mputa@treasury.gov.za or by fax to 012 315 5516. Please ensure that the comments reach us by 19 March 2009.