BACKGROUND NOTE

2011 DRAFT TAXATION LAWS AMENDMENT BILLS: REVISED PROPOSALS ON SECTION 45 INTRA-GROUP, HYBRID SHARE AND RELATED MATTERS

I. Background

The Draft Taxation Laws Amendment Bills, 2011 (draft Bills) were publicly released on 2 June 2011. These Bills come during a difficult economic period when global growth continues to be subdued, along with slowed prospects for revenue growth. Under these conditions, it is critical to guard the fiscus against structural weaknesses within the tax system and aggressive tax schemes that undermine principles of equity and the revenue base. It is in this context that Government is determined to take action against excessive debt stemming from section 45 transactions, as well as schemes involving hybrid shares. Continuing losses from pre-existing deals are already estimated to be on the order of R3 to 5 billion per annum.

The use section 45 in leveraged buyouts reached their peak in 2007 to 2008. At that time, many countries began to take measures against excessive debt, including reduced debt ceilings and limitations against excessive interest claims. Concerns in this area diminished during the global financial crisis and subsequent recession, but began to resurface in South Africa at the beginning of 2011 as the economy began to recover.

From the outset, it was fully recognised that a long-term solution was required to protect the fiscus. Many of the debt instruments of concern contained significant equity-like features. Large proportions of debt are financed by entities that do not pay tax on interest receipts whilst deductions for interest are claimed in full. In the most aggressive schemes interest deductions are the start of a long-chain of payments, through multiple entities, with the same funds ultimately returning in the form of exempt preference dividends. These latter schemes were identified in 2007 as “funnel schemes.”

Given the imminent risk of further significant losses, it was proposed that section 45 be suspended for an 18-month period so as to provide the fiscus with the opportunity to fully investigate and address the longer-term structural concerns. The suspension of section 45 was chosen as it was widely used to facilitate highly leveraged buy-outs. This suspension was to take effect as of 3 June 2011.

Following the release of the proposal, National Treasury and SARS sought further information from interested parties. This culminated in a week of meetings, consisting of more than 30 consultations relating to more than 50 transactions. National Treasury and SARS would like to thank the participants. Those engaged in more aggressive transactions were less forthcoming but some individuals disclosed critical information that pinpointed the precise areas of concern. These latter participants deserve special thanks.

Given the additional facts provided, a new solution is now being proposed for the short term. This revised short-term solution should better accommodate the pressing needs of the business community while simultaneously providing effective interim protection for fiscus. A longer-term set of solutions to deal with excessive debt and the characterisation of debt is still planned for 2012 and beyond. SARS will continue to investigate a number of pre-existing aggressive transactions that deliberately avoid paying their fair share of the tax burden.

The effective date of the proposals relating to section 45 will remain 3 June 2011. National Treasury and SARS reserve the right to take decisive action to protect the fiscus against excessive revenue losses. South Africa is not alone in this regard. Many countries occasionally employ effective dates in advance of formalised legislation to introduce tax measures to protect the fiscus. In a modern era of high-finance fuelled by fast moving technologies, Government cannot be expected to passively wait while deals costly to the fiscus continue unabated.

II. Revised short-term approach

As discussed above, the consultative process confirmed National Treasury and SARS's concerns in respect of excessive debt. It is accordingly proposed a section be introduced to control the interest deductions associated with debt used to fund the acquisition of assets in section 44, 45 or 47 transactions. Transactions will follow different channels. Interest deductions arising from transactions in the green channel will be automatically permissible. Interest deductions on associated debt for amber transactions will only be permitted upon pre-approval. Transactions that are not approved will not be permitted an interest deduction. This approach is guided by the need to reduce administrative burdens for most legitimate transactions. In the light of this approach the suspension of section 45 will no longer be necessary.

- *Green transactions:* Sections 44, 45 and 47 reorganisations that do not involve interest-bearing debt will be able to use the relief without approval by SARS. Preference shares will also be allowed as permissible funding mechanisms for section 45 transferred assets. However, the tax cost associated with intra-group debt and preference shares will be subject to tighter restrictions.

- *Amber transactions:* Sections 44, 45 and 47 reorganisations that utilise interest-bearing debt will fall into the amber category. Amber transactions will fall within two broad groups. Firstly, if the interest-bearing debt associated with these transactions is funded within the group of companies and results in no revenue loss (or the possibility of loss), automatic pre-approval is envisioned. Secondly, a discretionary approval process will apply only if the interest-bearing debt within

the arrangement may result in a revenue loss. The decision to approve or deny will depend on the impact of the interest to be incurred on the tax payable by the debtors and creditors acting as parties to the debt as well as the debt versus share features of the debt.

From the above consultations, it should be noted that the initial findings relating to section 45 allow for these transactions to be categorised into the following four broad sets of transactions:

- *Pure intra-group transfers:* The first set involves pure intra-group restructuring of long-held assets to enhance economic efficiency, where debt may or may not be a significant consideration.

- *Group vendor financing:* The second set involves the transfer of a business to a newly formed company to be held partially by minority shareholders (often accompanied by newly issued debt so as to reduce the net value of the newly formed company).

- *Leveraged buyouts:* The third set involves the acquisition of a business in a manner that permits an interest deduction (that would otherwise not be available) where debt is a key consideration (i.e. a leveraged buyout).

- *Securitisations:* The fourth set involves the transfer of assets into a special purpose vehicle as part of a securitisation for external financing.

In terms of the channel approach, pure intra-group transfers and group vendor financing should largely fall into the green channel. Leveraged buyouts and securitisations should largely fall into the amber channel. Their approval will depend on whether the interest payments are ultimately exempt and the level and nature of debt involved.

Group reorganisation transactions that are not disclosed to SARS in terms of the above proposals will be the subject of a specific tax return.

The revised proposal will retain the 3 June 2011 effective date for interest-bearing debt arising from section 45 transactions. The proposal for interest-bearing debt arising from section 44 and 47 transactions will apply from 3 August 2011.

III. Hybrid (e.g. preference) shares

The draft Bill contains a variety of measures to curtail the use of hybrid (e.g. preference) shares. Although these instruments are of continued concern (especially if the dividends are indirectly derived from interest-bearing debt), preference share funding is often used to acquire controlling share interests in an operating company or as a tool for black economic empowerment transactions. Preference share funding used in this fashion seeks merely to preserve tax neutrality (not to create revenue losses). In view of these considerations, the proposals involving hybrid shares will be altered as follows:

- *Extended redemption period:* The proposal to increase the minimum redemption period for preference shares to ten years will be withdrawn. The minimum redemption period will remain at three years and a day.

- *Third-party backed shares:* The main target of the proposal is the acquisition of shares that have debt-like features due to third-party backing. Because third-party backed shares are often at the core of tax avoidance, the proposal will remain but will be narrowed so as to exclude commercially driven transactions that are less likely to lead to revenue losses.

    - *Limited guarantees permissible:* Preference share funding will continue to qualify for dividend treatment if the preference shares are used directly or indirectly to fund the acquisition of ordinary shares of an operating company. This permissible use of funding can come in various forms (e.g. put options and guarantees).

    - *Focus on yields versus capital value:* Impermissible backing will now relate only to the nature of the preference share yield (e.g. dividends) as opposed to any guarantee of share capital value. This narrowed limitation will ensure that the proposal does not have an adverse impact on the main-stream use of derivatives to fully hedge the value of shares typically found when trading.

- *Preference dividends derived from interest:* One transaction of ongoing concern is the use of preference share funding where the dividends are directly or indirectly derived from interest-bearing notes. These notes are often pledged as collateral or held by a special purpose vehicle with an obligation to fund preference share short-falls. Preference share dividends of this nature will now be treated as ordinary revenue if directly or indirectly derived mainly from interest-bearing instruments.

V. Employee and black economic empowerment trusts

In 2010, an amendment was made to close certain avoidance schemes involving employee trusts. At the core of these schemes are shares whose sole value lies in their dividend yield. The net effect is additional salary disguised as tax-free dividends. Whilst the objective of the amendment remains valid, the amendment was overly broad, creating ordinary treatment for certain dividends derived from shares held in trust. This ordinary treatment even applied to standard employee and black economic empowerment trusts.

The problem of the overly broad nature of the anti-avoidance legislation was identified in the draft Bill but its resolution was left to regulations. A more precise solution is now proposed. Under the revised proposal, specific relief will exist for trusts whose sole assets consist of ordinary shares.

VI. Longer-term concerns

A. Excessive debt

As discussed above and in the media statement released on 2 June 2011, the use of section 45 to connect assets to excessive debt is part of larger problem. The more notable aspects of this problem include:

- The use of excessive debt to eliminate substantial amounts of operating income for an extended duration;
- The seeming freedom to recharacterise shares as debt (or debt as shares) with little regard for accounting and commercial concepts; and
- The need to allow for interest deductions stemming from leveraged buyouts, regardless of the form of the acquisition.

These issues will remain the object of investigation for legislation in 2012 in respect of new structures as well as pre-existing structures that operate to the continuing detriment of the fiscus. The experience of jurisdictions that have already imposed limits in respect of debt and the deductibility of interest thereon will be considered as part of this investigation.

B. Small clique of aggressive advisors and intermediaries

While many advisors and intermediaries properly view tax as a necessary societal obligation, a small set of advisers and intermediaries lie at the core of the most aggressive schemes of concern. The taxes saved in respect of these schemes are often a key element used to fund their substantial fees. Well-versed in these affairs, aggressive advisors and intermediaries typically take steps to insulate themselves from any potential reversal of the tax benefits they plan or facilitate. It is questioned whether these advisors and intermediaries should be allowed to insulate themselves in this manner.

A mechanism for holding advisors and intermediaries acting as promoters for aggressive tax transactions more directly accountability (via direct penalties or otherwise) is under investigation. It is must be reiterated that the issues relating to excessive debt arise at a time of huge fiscal challenges and developmental needs. It is improper and immoral for advisors and intermediaries to raid the fiscus so that their short term interests are placed above the national interest.

VII. Further public comment requested

In view of the above, National Treasury and SARS urgently request further public comment on the revised proposals, including any additional criteria that should be considered for the amber channel. As before, comments fully describing the facts relating to the transactions of concern will be viewed as more persuasive than purelylegal assertions. Comments should be submitted to the National Treasury via

Nomfanelo Mpotulo at Nomfanelo.mpotulo@treasury.gov.za and to SARS via Adele Collins at acollins@sars.gov.za by 17 August 2011.

In terms of the general process, a response document with respect to the draft Bills, including the revised proposals, will be published in late August / early September. The Taxation Laws Amendment Bills are anticipated to be formally introduced in Parliament in September 2011.

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