INTRA-GROUP ROLLOVER CONSIDERATION

(DRAFT DATE: 3 August 2011)

[Applicable provision: Section 45]

I. Background

Section 45 provides rollover treatment for the transfer of assets from one company to another as long as both companies are part of the same group of companies. This transfer can be in exchange for cash or in exchange for a note issued by the transferee, but not in exchange for shares issued by the transferee. If the transferor receives a note issued by the transferee, the tax cost equals the fair market value of the note at the time of issue.

II. Reasons for change

The fair market value tax cost of the note can give rise to avoidance in the case of appreciated assets because a fair market value tax cost exists for the note, even though the transferor receives rollover treatment for the appreciated assets. This treatment differs from section 42 rollovers, which also allows for deferral of the transferred assets. However, unlike section 45, any consideration issued (i.e. preference shares) in exchange under section 42 have a rollover base cost (as opposed to a fair market value base cost).

In 2007, the tax-free increase in tax cost was identified as problematic, but an interim solution was proposed. This second best solution requires re-examination given the on-going problems associated with section 45. The exclusion of any shares as consideration in a section 45 transaction is also problematic, especially since preference shares may pose less of a risk to the fiscus.

III. Proposal

A. Permissible use of preference shares

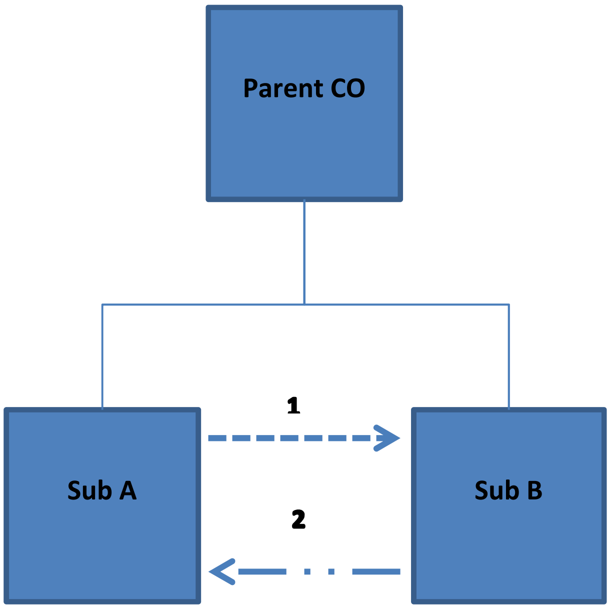
The use of preference shares as consideration for section 45 transferred assets will now be permitted. This use of preference shares does not overlap with section 42, the latter of which excludes preference shares. Preference shares is a useful tool in section 45, especially if the section 45 transfer is part of a shift to owners outside the group (up to 30 per cent). Preference shares are often preferred in this instance because the newly formed entity with outside shareholders often lacks the income to absorb the interest expenses associated with debt.

B. Revised tax cost for notes or preference share consideration

The tax cost for notes and preference share consideration within the context of section 45 raises two sets of issues. Rollover tax cost is the most appropriate result (like section 42) if this consideration is transferred to parties outside the group because an elevated tax cost can act as an indirect form of exemption. On the other hand, repayment of a note or preference shares within the group should not give rise to taxable gain or income because the repayment represents a mere internal group shift.

It is accordingly proposed that notes and preference shares issued as consideration under section 45 have a split impact. These notes and preference shares will have a tax cost of nil. However, any gain or income from the repayment of notes or preference shares will be exempt if the notes or preference shares are repaid whilst both parties to the notes or preference shares remain together within the same group of companies.

EXAMPLE



Facts: Parent Co owns all the shares of Sub A and Sub B. Sub A and Sub B are accordingly part of the same group of companies. (Step 1) Sub B wants to acquire some of the assets of Sub A with a market value of R80 million, a book value of R50 million and a tax value of R35 million. Sub A transfers the wanted assets to Sub B. (Step 2) Sub B issues an interest-free loan of R50m (equal to book value) to Sub A in consideration for the acquisition of the assets.

Result: The transaction will qualify for the intra-group transaction relief. Sub A will be deemed to have a tax cost of zero on the loan. To the extent that Sub A and Sub B are still members of the same group of companies, any gain or income realised by Sub A as settlement of the loan principle will be disregarded for the purposes of determining Sub A's gain and income.

IV. Effective date

The proposed amendments will apply to all disposals occurring on or after 3 June 2011.