ACQUISITION DEBT ARISING FROM REORGANISATION ROLLOVERS

(DRAFT DATE: 3 August 2011)

[Applicable provisions: new section 23K]

I. Background

Taxpayers may not generally deduct interest incurred in respect of loan funding used to acquire shares because shares generally only produce exempt income. However, taxpayers can indirectly obtain a deduction for interest when acquiring shares of a target company when the acquisition is associated with certain rollover reorganisation, especially section 45.

The most common technique for indirectly obtaining an interest deduction for share acquisitions is known as the section 45 debt push-down technique. In its simplest form, the debt push-down technique is used when acquiring all of the shares of a target company. The first step typically involves the purchase of the target company shares with self-funded cash or with cash from a bridging loan. In the second step, the acquiring company transfers the assets of the target company into a newly formed subsidiary pursuant to a section 45 rollover with the assets paid from external bank funding. The target company then liquidates with the bank funding used to pay off the bridging loan. The interest from the bank loan is seemingly viewed as deductible because the loan is linked to the direct acquisition of assets (see ITC 1625).

II. Reasons for change

The reorganisation rollover rules were merely intended to facilitate the transfer of assets in specified circumstances. The rollover rules were never intended as an enabler for interest deductions when those deductions would not otherwise be available. However, the use of the reorganisation rollover rules as a means to allow for interest deductions when acquiring shares is said to be necessary when the seller refuses to sell underlying company assets as opposed to shares. It has also been said that this technique is necessary because the South African tax system is an outlier in respect of global tax systems by disallowing interest when used for share acquisitions.

In many settings, the above use of section 45 and other reorganisation rollover rules does not jeopardise the fiscus. Interest deductions for the borrower are often matched by taxable interest income for the creditor. However, the fiscus is at risk if the interest is paid to parties that are not subject to tax on the interest or that have on-going losses to absorb the interest income.

Unfortunately, the use of section 45 and other reorganisation rollovers as a tool to achieve the mismatch of interest deductions vis-à-vis the exempt receipt of that interest has become all-too-common. The nature of the transactions of concern involves large amounts of debt with many aggressive transactions utilising debt with share-like features (including soft shareholder loans). In the most aggressive schemes, the interest paid is artificial, being re-routed back to the same economic group via tax-free preference share dividends.

III. Proposal

A. Initial proposal

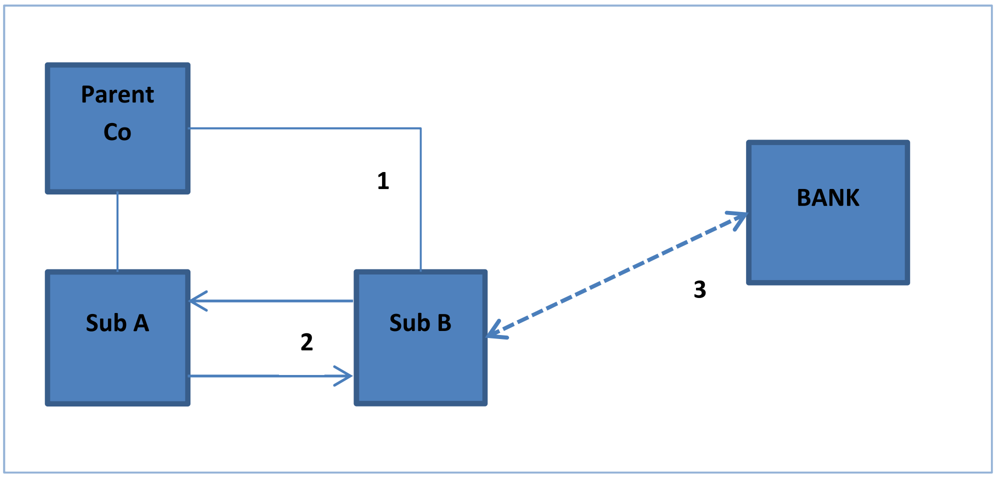
Given the above, it was initially announced that section 45 rollover relief would be wholly suspended for a period of approximately 18 months. The purpose of this suspension was to provide the fiscus with some breathing space to re-evaluate the tax system so as to prevent the ongoing use of excessive debt payable to exempt (or loss-making) parties. This proposal was widely criticised as overly broad, undermining the use of section 45 even when the overall arrangement did not effectively undermine the fiscus.

B. Revised proposal

In order to strike a more refined balance between the need to protect the fiscus versus the need to facilitate commerce, multiple consultations were conducted with various private stakeholders. The proposal to suspend section 45 has accordingly been dropped.

Instead, interest deductions in respect of debt used to facilitate section 44, 45 and 47 reorganisations will be controlled (as well as interest deductions for debt that refinances or other substitutes the initial debt). More specifically, interest associated with this debt will no longer be automatically deductible (see discretionary process below).

If the interest is non-deductible by the payor, then the holder of the debt instrument will be treated as receiving dividends. This applies if the payor and the holder of the debt instrument are part of the same group of companies.



EXAMPLE

Facts: Parent Co owns all the shares of Sub A (newly acquired) and Sub B. Sub A has assets with a value of R 1 billion. (Step 1) Parent Co sets up Sub B (newly formed) to acquire all of the assets of Sub A. (Step 2) Sub B then acquires all of the assets of Sub A in exchange cash (3) Sub B obtains this cash via an interest bearing loan from Bank.

Result: The transaction will qualify for the intra-group transaction relief, but the interest deduction in respect of the loan to acquire the assets will not be automatically allowed. The interest deduction may be allowed if the Commissioner is satisfied that the incurral, receipt and accrual of the interest does not significantly erode the tax base (see below).

In order to obtain "interest" treatment, taxpayers will generally be required to obtain pre-approval from SARS after consultation with the National Treasury. At issue for obtaining this pre-approval is whether the incurral, receipt or accrual of interest will lead to a significant erosion of the tax base. The criteria for the determination will be based on Ministerial regulations. At this stage, the criteria envisioned are (i) the tax impact of the interest payments on the debtors versus the payee, (ii) the terms of the debt used to finance the intra-group asset acquisition, (iii) the debt versus equity features of the debt used to finance the intra-group asset acquisition, and (iv) the tax versus commercial purpose of the transaction.

The above pre-approval is based on the facts in existence at the time of the pre-approval request. If material facts change (i.e. the terms of the debt change, or the debt is cancelled or substituted), the pre-approval is no longer valid. In this circumstance, a new pre-approval is required for the payments to retain their deductible character.

The Minister will also be given the power to exclude transactions from the pre-approval process. This exclusion is intended for transactions that represent little or no risk to the tax base (for example, pure intra-group transactions).

IV. Effective date

In respect of debt arising from a section 45 transaction, the proposed amendment will apply in respect of any asset acquired on or after 3 June 2011 but before 1 January 2014. In respect of debt arising from a section 44 or 44 transaction, the proposed amendment will apply in respect of any asset acquired on or after 3 August 2011 but before 1 January 2014. The proposed amendments are intended only to be of a temporary nature. A more permanent solution is envisioned to remedy the issues relating to excessive and hybrid debt. The facts obtained from the proposed approval process will be used as one mechanism to facilitate this more permanent solution.