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RE: ANNEXURE C PROPOSALS FOR 2018 BUDGET: CORPORATE INCOME TAX

We have attached the Annexure C Proposals from the SAIT Business Taxes Work Group. We appreciate the opportunity to participate in the process and would welcome further dialogue.

Please do not hesitate to contact us should you need further information.

Yours sincerely

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ANNEXURE C SUBMISSIONS FOR 2018 BUDGET: CORPORATE INCOME TAX

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ANNEXURE C SUBMISSIONS FOR 2018 BUDGET: CORPORATE INCOME TAX

1. INNOCENT COMMERCIAL TRANSACTIONS HAMPERED BY WIDE IMPACT OF NEW DIVIDEND STRIPPING RULES (UNINTENDED CONSEQUENCE)

Our comments arise from the proposed amendment of s22B and par 43A of the Eighth Schedule to the Income Tax Act by the 2017 Taxation Laws Amendment Bill. We are of the view that the proposed amendment will give rise to unintended consequences by adversely impacting wholly innocent transactions that should be fully allowed as a policy matter.

1.1 The legal nature of the problem

The new dividend stripping rules have a much wider impact than the mischief that they seek to address. The mischief is essentially that the seller of shares in a company could structure a sale of the shares to another person to receive a tax-exempt dividend instead of taxable proceeds. The transactions typically have two steps – a direct or indirect purchaser contribution to the company, followed by a dividend / buyback for the seller. These dividends are funded, directly or indirectly by the purchaser contribution. We understand the government concern that this provision must be drafted widely to prevent the various forms of mischief involved. Unfortunately, the proposed new dividend stripping rules go too far and adversely impact wholly innocent transactions that should be fully allowed as a policy matter.

There are a number of wholly innocent commercial transactions that are being adversely affected that do not involve any outside purchaser. We are concerned that the newly introduced anti-avoidance rules change the fundamental principles applicable to these innocent transactions. In particular, the new rules fundamentally alter the policy position reflected in paragraph *(b)* of the definition of a dividend in section 1, namely that an amount paid by a company to a shareholder to acquire shares in that company should have the same implications as any other dividend for tax purposes.

These affected transactions include corporate shareholders that are involved in, inter alia:

- Straight-forward share buybacks
- Straight-forward liquidations

We note that these problems have emerged upon an early reading of the new provision. We suspect other corporate transactions may be adversely impacted (e.g. mergers with corporate shareholders and double distributions in specie i.e. unbundling type distributions).

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1.2 Detailed factual description

The factual descriptions can best be provided by way of examples:

Example 1: Straight-forward share buyback from existing reserves

<u>*Facts*</u>*:* Parent Company owns 700 ordinary shares of Subsidiary and BEE Company owns 300 shares of Subsidiary. Assume that all companies are domestic; the shares are valued at R1 million each; and the ownership structure has existed for 5 years. What happens if Subsidiary buys back 10 per cent of its shares from the parent, thereby increasing BEE Company's interest in Subsidiary without any further investment by BEE Company being required?

<u>*Outcome*</u>*: Pre-2017 TLAB:* The share buyback will be treated as a dividend under the section 1 definition (unless a capital distribution is chosen). Dividends between domestic companies are tax-free. If the value distributed to Parent Company is ultimately distributed by it to its non-company shareholders, the distribution of the value will be taxed. If the distribution of value had been taxed at the level of Parent Company as well as its shareholders, the distribution of the same value will be taxed more than once. No losses will result upon the corresponding disposal of the shares (see paragraph 19(1) of the 8th Schedule).

2017 TLAB: The share buyback itself triggers new paragraph 43A, thereby converting at least 85% of the tax-free dividend into a taxable transaction. This outcome applies even though no external funding is involved. For purposes of the anti-avoidance rule, Parent Company is "disposing of shares in another company" [Subsidiary], and there is an "exempt dividend received by or accrued to that company [is] in respect of the share disposed of". 85% of the dividend will be "extraordinary" and treated as proceeds. If the same value extracted from Subsidiary to Parent Company is distributed by it to its ultimate shareholders, this value will be subject to dividends tax.

Example 2: Straight-Forward Liquidations

<u>*Facts*</u>*:* Parent Company owns all the ordinary shares of Subsidiary. Subsidiary has ceased business and disposed of all its assets. As a result, Subsidiary has cash equal to its accumulated retained earnings (assume for purposes of this example, R25 million). Subsidiary is liquidated. As part of the liquidation, Subsidiary distributes the cash (and by implication its retained earnings) to Parent Company. As part of the liquidation, Parent Company surrenders all of its shares in Subsidiary.

<u>*Outcome*</u>*: Pre-2017 TLAB:* The distribution of the accumulated cash would be treated as dividends (unless capital treatment is chosen), which are exempt if paid to company shareholders. If Parent Company were to distribute the cash to shareholders that were not South African company, the distribution would then be subject to dividends tax.
2017 TLAB: The distribution of the accumulated cash will be a dividend (unless capital treatment is chosen), which is exempt if paid to a company shareholder. Parent Company will receive this dividend in the course of the liquidation process during which

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it also disposes of its shares in Subsidiary when these shares are cancelled. 85% of the distribution will constitute extraordinary dividends and be taxed as proceeds on the disposal of the Subsidiary shares in the hands of Parent Company. If Parent Company were to distribute the cash to shareholders that were not South African company, the distribution would be subject to dividends tax. The result is multiple layers of tax being imposed on the extraction of the same after-tax profits (in this instance, R25 million) from a South African company.

The result in both of the above scenarios is multiple layers of tax being imposed on the extraction of the same after-tax profits from a South African company. It is submitted that this outcome is a fundamental change in the policy position regarding taxation of distribution of after-taxed profits reflected in the Explanatory Memorandum to the 2008 Revenue Laws Amendment Bill, which stated that the company-to-company exemption was based on a classical model of taxation of dividends (in which the underlying profits of companies are taxed in the companies and dividends are taxed in the hands of shareholders when dividends leave South African companies). We are of the view that such a fundamental variation, which significantly affects taxpayers entering into innocent commercially motivated transactions, requires further consideration as it will adversely impact funds available for investments by domestic companies, which would ultimately hamper economic growth.

1.3 The nature of the business impacted

This could typically impact a holding company which receives a dividend from its subsidiary and disposes of shares in its subsidiary where there is a link between the dividend and the disposal.

2. DEBT BENEFIT TRIGGERED BY A CHANGE IN ANY TERM OR CONDITION OF A DEBT

This trigger forms part of proposed substitution of section 19 and paragraph 12A of the Income Tax Act contained in 2017 Taxation Laws Amendment Bill.

2.1 The legal nature of the problem

A change "in any term or condition" of a debt would require the amount of the debt benefit to be quantified and to be subjected to the tax consequences flowing from a concession or compromise of a debt.

2.2 Detailed factual description

For example, if a subsidiary has a loan from its holding company, and the holding company (even temporarily) subordinates the loan in favour of the subsidiary's creditors to restore the subsidiary to solvency so that it can retain its going concern status (for audit and other purposes), the subsidiary is likely to suffer these tax consequences. There is also no group exemption in relation to this trigger.

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We refer to the joint submission made by SAIT and SAICA to present concerns discussed by participants from various accounting and law firms in relation to the new proposal: <u>Collaborative submission by SAICA and SAIT on the revision of debt reduction proposals in Draft 2017 Taxation Laws Amendment Bill – significant new addition: debt benefit triggered by change in any term or condition of a debt</u>

As set out in the joint submission, we have various reservations, in principle, regarding the proposal which triggers tax consequences even if the amount of the debt remains outstanding and unchanged. These reservations include:

- This trigger makes debt rescue harder when companies are increasingly under economic distress as tax could be triggered in the hands of the debtor at the point when the parties seek to rescue the debt;
- Taxing an unrealised debt benefit calculated based on the fair value of the debt is a significant departure from the receipts/accruals basis of tax;
- The decrease of the market value of the debt below the face value should not attract tax while the debt remains outstanding and the intention is to repay it;
- The requirement to track each change of a term or condition of a debt is a trap for the unwary as many taxpayers are simply not tax aware and sophisticated enough;
- The requirement to value the debt each time that there is a change in a term or condition in order to quantify the debt benefit, if any, is incredibly onerous;
- It is often necessary to value the underlying business of the debtor in order to be able to value the debt claim, particularly where the debtor is not liquid and solvent as would often be the case;
- Debt claim valuations are often complicated, time-consuming, costly and involve assumptions and judgement;
- These valuations will be open to drawn-out disputes between SARS and taxpayers.

We also note that the proposed wording contained in the TLAB in this regard, is not clear. For example:

- There is no mechanism to take into account previous debt benefits. Therefore, it is possible that a debt benefit could be doubled-up when, say, a debt is first changed from interest-bearing to interest-free and then later totally waived.
- There is no mechanism to reverse the tax consequences of a debt benefit if the relief provided by the creditor is subsequently removed, for example when a holding company no longer subordinates its loan to its subsidiary (e.g. after the subsidiary becomes solvent).
- Certain debts which are treated as equity for tax purposes to prevent tax-avoidance will, anomalously, also suffer debt benefit consequences, e.g. section 8F hybrid debt instruments.

We strongly recommend that the proposal that the change of terms or conditions of a loan would trigger a debt benefit should not be proceeded with (or at least delayed until 2019). We suggest that, if National Treasury wishes to proceed with this proposal, adequate consultation should take place in a future full legislative cycle, as the

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consequences of such a change are likely to be significant and cannot all be foreseen and considered at this stage. If this trigger is retained, we recommend that there should be group exemption in relation to this trigger, similar to the group exemption for debt to equity conversions.

2.3 The nature of the business impacted

Any business that has borrowed money to fund deductible expenditure, allowance assets or capital assets if any of the terms or conditions of the debt is changed.

3. SECTION 45 AND INVENTORY SOLD BETWEEN GROUP COMPANIES

3.1 The legal nature of the problem

The provisions of section 45 of the Income Tax Act apply unless the parties elect out of the provisions. Trading stock is effectively deemed to have been transferred between group companies at the lower of cost or net realisable value as the transferee steps into the shoes of the transferor.

3.2 Detailed factual description

This poses a problem where groups of companies regularly transfer inventory from say a manufacturing company within the group to a distribution or retail entity. Unless the parties elect out of the provisions of section 45 as and when inventory is moved between the companies, the manufacturing concern will automatically be deemed to dispose of the inventory at cost. We suggest that the section 45 treatment of trading stock should rather require an active election-in by the parties than an election-out so that both parties can be taxed in the normal course, in line with their accounting treatment, unless they actively elect-in.

3.3 The nature of the business impacted

Businesses who sell inventory to group companies.

4. SECTION 42 ASSET-FOR-SHARE TRANSACTIONS: TREATMENT OF LIABILITIES ASSUMED (UNINTENDED CONSEQUENCE)

4.1 The legal nature of the problem

If the shares acquired in an asset-for-share transaction are subsequently disposed of, the capital gain normally equals the commercial profit. However, when these shares are transferred again under the corporate rules, there is an unintended consequence that a capital gain will arise in stead of roll-over relief being obtained.

4.2 Detailed factual description

This section 42(8), read with section 42(4) allows certain qualifying debt to be assumed by the acquiring company without CGT having to be paid.

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When assets are exchanged and liabilities are assumed, the shares that are issued by the acquiring company have a base cost in the disposer's/shareholder's hands equal to the base cost of the assets transferred. Section 42(8) then goes on to state that, when the shares are disposed of, the face values of the debts must be treated as an amount received or accrued in respect of the disposal of the shares.

With an ordinary sale of shares this will not present any problem. Take the following simple example: A person disposes of a business as a going concern to a company under section 42 of the Act where the base cost of the assets is R100 and the liabilities assumed amount to R60, resulting in shares being issued to the value of R40. What the section states is that the disposer receives that R40 worth of shares but they have a base cost of R100, equal to the base cost of the assets. Assume that after a while the shareholder sells the shares (which commercially had a cost of R40) for R70, thereby making a profit of R30. For CGT purposes the base cost was R100. The actual proceeds would have been R70, but one must add the amount of the liabilities of R60 to these proceeds, giving total deemed proceeds of R130. One then deducts the base cost of R100, giving rise to a capital gain of R30, which then equals the commercial profit.

Where the shares are exchanged for shares in another company using section 42 of the Act; or they are transferred in terms of an amalgamation transaction under section 44; or under an intragroup transaction under section 45; or they are unbundled under section 46; or they are distributed in terms of a liquidation distribution under section 47 one would also expect that there would be roll-over relief. However, because section 42(8) does not give a carve-out for these transactions it means that, although the shares will be deemed to be disposed of for R100 under those sections in this example, i.e. the base cost, it also means that one must add the value of the liabilities, being R60, to the proceeds, i.e. to R100, and since the base cost is R100, it means there is now a capital gain of R60 instead of rollover relief.

4.3 The nature of the business impacted

Any company which acquired equity shares in an asset-for-share transaction and subsequently transfers them again under the corporate rules.

5. LIMIT ON DEBT OWED TO EXEMPT PERSONS (SECTION 23M) – LEVEL OF CONTROL

5.1 The legal nature of the problem

Section 23M limits deductions when interest payments are made to exempt creditors. The purpose of this anti-avoidance rule is to prevent excessive deductions in terms of shareholders who are economically indifferent as to whether instruments held are shares or debt because the nature of the instruments can be changed at will due to the shareholder’s high level of control. In the base case of concern, a sole shareholder of a company can choose debt or shareholder loans without consequence (and can effectively change the nature of the instruments without economic consequence).

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5.2 *Detailed factual description*

At issue is the level of the ownership test for section 23M. A 50 per cent level is completely insufficient to exercise the kind of control necessary for an exempt party to be indifferent as to whether the instruments are shares or debt. A 50 per cent shareholder simply cannot choose and reconfigure these instruments in isolation from other shareholders (i.e. lacks the unilateral control to be indifferent as to whether the instrument is a share or debt).

Minimum request: The 50 per cent threshold should at least be changed to a "more than" 50% level as a demonstration of control. This change would match the international standard of other EBITDA cross-border limitation rules. Even our CFC regime requires more than 50% shareholding for control.

5.3 *The nature of the business impacted*

Real Estate Investment Trusts (REIT's) often obtain debt funding from local pension funds that could also hold 50% or more of the equity shares in the REIT and are then adversely impacted.

Note: We again repeat that this test remains a significant challenge for mining companies because companies with mining rights are required to have a minimum 26 per cent minority due to the BEE empowerment codes imposed by the Department of Minerals and Energy. In order to make these rights more affordable, debt is often held by the majority mining company (with preference shares not being an option given their risk to the required BEE percentages). Relief again should be considered in this regard.

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