South African Institute of Tax Professionals

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The National Treasury

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RE: DRAFT TAXATION LAWS AMENDMENT BILL (TLAB), 2017: COMMENTS PERTAINING TO KEY BUSINESS TAX ISSUES

We have attached the comments from the SAIT Business Tax Work Group on the 2017 draft Taxation Laws Amendment Bill pertaining to key business tax issues. 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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BUSINESS TAX ISSUES

A. SHARE BUY-BACKS AND DIVIDEND STRIPPING ANTI-AVOIDANCE RULES (Proposed substitution of section 22B / Paragraph 43A)

1. Treasury proposal

The proposed amendment rightly seeks to end the current mischief associated with a growing number of subsidiary shares sales by parent companies. It is well-known that many parent companies no longer simply sell shares in a controlled subsidiary but instead become entangled in share buy-backs and similar schemes. All of these schemes seek to artificially convert capital gains upon the sale of shares into tax-free dividends wherein the sale is disguised in a different form.

The proposed substitution of section 22B and paragraph 43A seeks to broaden the application of the current anti-avoidance rules via a much more blunt approach. Under the revised rules, any dividend preceding the sale of subsidiary shares triggers an increase in capital gain upon the disposal of the shares. The dividend need not be directly or indirectly funded by the purchaser.

2. Problem #1: Over-Taxation of Ordinary Dividends

a. Background

We note that the real abuse of dividends preceding the sale of shares arises only where the dividend is directly or indirectly funded by the purchaser. However, we understand that the tracing of funds to dividends may be impractical for SARS.

That said, we still suggest that the new anti-avoidance rules be narrowed to exclude wholly innocent transactions.

- Firstly, many sales of subsidiary shares are preceded by normal dividends wholly unrelated to the sale. In this vein, we suggest that the new anti-avoidance rules be limited to extra-ordinary dividends (see paragraph 19 of the 8th Schedule).

- Secondly, dividends may come in the form of reorganisations (e.g. unbundling and liquidations). For instance, assume Parent Company holds all of the shares of Sub 1 and Sub 1 owns all the shares of Sub 2. Sub 1 may unbundle Sub 2 (as an unwanted asset by the purchaser). Parent could then fall foul of the new anti-avoidance rule if Parent Company sells the shares of Sub 1.

- Thirdly, the proposed rules fail to account for certain indirect group sales that are wholly innocent. For instance, assume Parent Company owns all of the shares of Sub 1, which in turn owns all of the shares of Sub 2. Sub 1 sells all of the shares of Sub 2. After the sale of Sub 2, Sub 1 distributes the proceeds of Sub 2 to Parent Company by way of dividend. Under this scenario, the new anti-avoidance rule applies the language that links the sale of Sub 2 shares to the dividend by Sub 1 (whereas the intention is only to target dividends by Sub 2 if shares of Sub 2 are sold).

Examples of normal dividends preceding a share sale:

i. Listed companies often pay regular dividends to the listed shareholders, which are often funded from dividends via lower-tier subsidiaries. These lower –tier subsidiaries could easily distribute dividends in the normal course before the listed group decided to sell the lower-tier subsidiary.

ii. Many unlisted companies are often forced to distribute regular dividends as part of their BEE shareholder commitments, which are often funded by lower-tier subsidiaries.

iii. Preference shares regularly generate dividends without regard to the timing of sale. These normal preference dividends may typically occur annually, six-monthly or quarterly. Preference dividends could also be accumulated and paid upon redemption (a disposal).

b. Suggested solution

The proposed anti-avoidance rules should not apply to dividends occurring within the ordinary course. A carve-out of this nature could possibly be based on paragraph 19, which only applies to extra-ordinary dividends (i.e. dividends falling 15 per cent above total sale proceeds). The schemes of concern are only effective if the dividend amounts are extra-ordinary in any event. As a practical matter, these dividends usually result in a negative reserve (or would dip into capital under old company law).

We also note that note that certain forms of dividends should be wholly excluded. The rule was primarily aimed at cash dividends. Yet, the word "dividend" could include a section 46 unbundling distribution or other tax-free reorganisation distribution, such as a distribution falling under the intra-group rules of section 45 (the latter of which has a whole series of claw-back rules to prevent disguised exits from the group).

Funding preference shares that are redeemed or disposed of at face value plus accumulated dividends should also be excluded as it would be inappropriate to recharacterize the coupon on the preference shares as additional proceeds on their disposal.

3. Problem #2 – Concerns About the Ownership Test

a. Background

The proposed legislation is triggered when the selling company and the target company to be sold have either a 50 per cent ownership connection, or the selling company has a mere 20 per cent share interest in the target when no other person holds the majority. We are concerned that this level of ownership is becoming far too low as an objective avoidance standard.

It must be stated at the outset that the vast majority of abusive transactions involve the sale of shares of a wholly owned subsidiary. Perhaps, a significant minority of shares sales may involve target subsidiaries involved a 70-per cent level of ownership (with black economic empowerment partners owning only 30 per cent). While SARS may be aware of handful of transactions falling below this level, we question whether Treasury should adopt objective legislation that targets this handful when this lower-threshold will most likely pick up a larger set of wholly innocent transactions where the dividend and sale are tied by mere happenstance.

b. Suggested solution

The ownership trigger should be retained at the current level of more than 50 per cent. If Government would like to take the matter slightly further, one could perhaps rely on the connected person test of section 1, which would additionally cover minority shareholders of 20 per cent where no majority shareholder exists.

We also point out that this reduction in percentages is becoming problematic in terms of other anti-avoidance provisions, such as section 23M (which also uses a 50 per cent threshold). Section 23M was designed to limit the interest deduction of debt owed by a South African subsidiary to a foreign parent. The concern is that the foreign parent chooses debt in lieu of equity because interest payments to the parent are deductible whereas dividend payments are not (i.e. a classic base erosion profit shifting concern). Nonetheless, this indifference exists only when the foreign parent has 100 per cent control of the subsidiary or the minority shareholders are inconsequential. Debt has a real economic consequence to real minority shareholders.

The net effect of section 23M has been to adversely impact genuine 50 / 50 joint ventures. The most notable being a sizeable real estate joint venture in Cape Town that is 50 per cent owned by the Public Investment Corporation. We accordingly again ask for relief in this area (with the test being moved to a "more than 50 per cent" test (and preferably a group test).

4. Simple Share Buybacks, Redemptions and Liquidations

a. Background

The proposed anti-avoidance legislation is triggered via two sets of timing rules. The dividend must either be 18 months "prior to" the share disposal. Alternatively, the dividend must be "in respect of, by reason of or in consequence of that disposal without regard to time.

b. Share buybacks, redemptions and liquidations 18 months prior to disposal

We note that every buy-back and redemption technically involves both a distribution and a disposal of the shares. The distribution portion typically occurs at the same time as the share disposal. One would accordingly assume that a straight buy-back or redemption of this kind would not implicate the anti-avoidance rules because the dividend does not occur "prior to" the disposal. That said, we believe this fact must be confirmed as a matter of company law and the tax law should be clarified accordingly (at least by way of explanatory memorandum).

We further note that liquidations will most likely give rise to unintended difficulties. In most liquidations, one or multiple distributions will most likely occur "prior to" the actual final withdrawal of the shares. We believe this answer is in error, however, because there is no outside party seeking to acquire the shares. Therefore, we suggest that liquidations be wholly excluded from the anti-avoidance rule.

c. Share buybacks, redemptions and liquidations in respect of, by reason or in consequence of the disposal

The second timing test presents a much bigger problem in terms of share buybacks, redemptions and liquidations. All of these distributions occur in respect of, by reason of or in consequence of the share disposal. We therefore suggest that this second timing rule be dropped or possibly that the dividend must be in respect of a different set of shares than the shares disposed of.

B. CLOSING CONTRIBUTED TAX CAPITAL SCHEMES INVOLVING FOREIGN-OWNED SOUTH AFRICAN SUBSIDIARIES (Section 8G)

1. Treasury proposal

Section 8G disallow the artificial creation of contributed tax capital of a South African subsidiary where: (i) the shares of that South African subsidiary are initially owned by a foreign company, and (ii) a Newco Holdco (another South African company) is interposed between the foreign company and the South African subsidiary. The key point is that the foreign company transfers the shares of the South African company to the Newco Holdco by way of a taxable asset-for-share transfer. The net result is that the foreign company obtains a fair market value amount of contributed tax capital in the Newco Holdco without tax (because foreign persons are not generally subject to capital gains tax on shares).

Once the foreign company has a market value contributed tax capital in Newco Holdco, this newly created contributed tax capital is used as a basis for withdrawing South African subsidiary funds in a tax-free manner. More specifically, the South African subsidiary distributes dividends to Newco Holdco because both are South African companies. Newco Holdco then makes a capital distribution to the foreign company. This capital distribution is then tax-free to the extent of the market value of the contributed tax capital because capital distributions either reduce the base cost in the Newco Holdco on a tax-free basis or give rise to non-taxable capital gain (because foreign persons are generally free from capital gains tax).

The proposed rules essentially reduce the contributed tax capital in the Newco Holdco to eliminate the avoidance of concern. It is intended that the contributed tax capital instead mirror the contributed tax capital of the pre-existing South African subsidiary.

2. Problem #1 – Section 42 Transfers

a. Background

The above anti-avoidance rule presumes that the foreign company obtains an uplifted market value amount of contributed tax capital in Newco Holdco based on the general rules for contributed tax capital. However, this fair market value amount will not exist if the transfer occurs via section 42 because section 42 would only result in a carry-over contributed tax capital based on the tax attributes of the foreign company's holdings in the pre-existing South African subsidiary shares.

b. Suggested solution

The proposed anti-avoidance rule should not apply if the Newco Holdco has obtained contributed tax capital by way of section 42 or other reorganisation transaction as long as the contributed tax capital is based on a carry-over determination. The abuse concern exists only where the contributed tax capital stems from the market value of group company shares contributed to the Newco Holdco.

3. Problem #2 – Unintended Wording

The proposed wording may have the unintended impact of applying when a new foreign company simply purchases South African holding company shares of a South African group subsidiary from another independent company. In cases of this kind, the purchase has no effect on the pre-existing contributed tax capital of the South African holding company. Yet, if one reads the proposed words carefully, the new anti-avoidance seemingly applies.

In particular, the foreign purchaser is using "consideration" to acquire the shares of the South African Newco Holdco and this "consideration" "is used directly or indirectly to acquire any shares of the South African group subsidiary" (as pronounced under proposed section 8G(2)). We do not believe that National

Treasury intended to strike at simple cash purchases of this kind. The term "indirect" was more likely aimed at share-for-share transactions involving the contribution of a holding company higher up the chain.

C. GENERAL NARROWING OF CURRENT DEBT RELIEF MECHANISMS

1. Background (current law)

Under current law, the cancellation of debt of a debtor is viewed as either capital gain or ordinary revenue for the debtor because the debtor is enriched by the debt relief (as if the debtor received cash proceeds). While this taxable result is correct as a matter of pure tax policy theory, paragraph 12A of the 8th Schedule and section 19 were enacted to provide partial relief from this immediate tax charge in order to facilitate various forms of business rescue and debt workouts. Government was concerned that the taxation of debt cancellations would simply mean that commercial debt would effectively return the debtor into insolvency if automatically subject to a new tax debt charge. Both provisions provide this relief by allowing the debtor to offset potential capital gain / ordinary income via a one-for-one substitution of capital gain / ordinary revenue tax attributes.

We further note that two other mechanisms currently exist that provide an even greater set of relief. The first relief mechanism is the wholesale exemption of capital gain when debt cancellations involved group members. The second (more informal) relief mechanism applies when an indebted company issues its own shares to a creditor in cancellation of debt. Both these mechanisms (and the attribute reduction rules described under paragraph 12A of the 8th Schedule and section 19) are consistent features of the tax debt cancellation landscape found in other jurisdictions. All these mechanisms mitigate adverse tax charges otherwise resulting for a debtor when debt is cancelled.

2. Policy Objections

Despite the explanatory memorandum discussion to the contrary, the proposed amendments essentially eviscerate the current system of group relief as well as the existing relief for share-for-debt transactions. The new dormant company rule is then suggested in the explanatory memorandum as a generous replacement when, in fact, debt of a dormant company is in-consequential by comparison to the mechanisms lost. We also note that the new dormant company debt relief mechanism is so laden with burdensome requirements as to have essentially no practical application at all.

a. <u>Point #1 – Economics over Tax Purity</u>

As an economic policy matter, one would think that National Treasury would be assisting distressed debtors during this period of economic distress. Many distressed companies need to be assisted when creditors provide debt relief in order to retain the debtor's long-term viability. Indeed, we understood that National Treasury was previously examining the possibility of extending the mechanisms for debtor relief further based on this practical understanding of the current economic landscape. The proposed amendments essentially go in the opposite direction. Purist tax theory should not be placed as a higher priority than weathering the current period of economic turbulence. More importantly for SARS, relief for distressed business means greater tax revenue for the longer-term future.

b. <u>Point #2 – Intra-Group Debt Relief is Sound Tax Policy</u>

The lack of taxation when cancelling debt amongst group companies represents sound and tested tax policy. Pure cancellation of debt between group companies essentially represents cash capital contributions within the group. Intra-group cash contributions have no adverse tax consequences whether transferred for shares or for no consideration at all. A group of companies represents a single economic unit, meaning that intra-group transfers receive deferral and intra-group dividends are exempt (even under the old Secondary Tax on Company regime ended many years ago).

We also note that intra-group debt cancellation of underlying debt capital are essentially neutral for the fiscus. The initial creation of the debt has no consequence for the creditor or debtor (see the well-known *Genn* decision). While cancellation of debt outside the group context does indeed trigger capital gain / revenue, the same cancellation generally triggers a similar loss for the creditor. Group relief means that the cancellation of gain for the debtor is matched by denial of the loss for the creditor, thereby retaining tax neutrality.

c. Point #3 – Relief for Shares Issued in Exchange for Debt is also Sound Tax Policy

Debt cancellation should only potentially give rise to adverse tax consequences for a debtor when the consideration for the debt cancelled falls below the amount cancelled. Even though SARS may view the issue of new shares as having no value, this perception is in error from a commercial vantage point. Banks and other creditors often surrender their creditor rights in debt owing to a company for that company's shares as a key mechanism for mitigating their potential loss on the underlying debt. This conversion is the essential ingredient of many debt rescue packages, where the creditor takes control over the debtor, restructures the indebted company and then sells the shares of the revitalised company as an offset against the losses stemming from the debt previously cancelled. Many of these debt-for-share swaps are value-for-value exchanges.

Example – Facts: Company X is in a distress situation. Company X has gross assets (including goodwill) of R5 million. Company X also owes R4 million of debt, including R3 million owed to Bank. Even though Company X has a net value of R1 million, Company X is currently facing cash-flow insolvency due in part to the high level of monthly interest on debt owing. Bank and Company X accordingly enters into a rescue package to save Company X. Bank agrees to cancel R2 million of the debt in exchange for 2/3rds of the shares. Immediately after the debt-for-share swap. Company X has a value of R3 million (R5 million gross less R1 million of third party creditor debt and R1 million of bank debt). Bank holds R2 million shares worth of equity in Company X (i.e. 2/3rd of R3 million).

Outcome: All parties are neutral because R2 million of debt is cancelled for the issue of shares worth R2 million immediately after the swap. In tax terms, no debt cancellation gain / income should arise because an equal value of shares are issued in exchange. Bank should similarly incur no tax loss because an equal value of shares were received in exchange for the debt cancelled.

3. Share-for-Debt Avoidance of Concern (Section 19B)

a. Background

According to the explanatory memorandum, the main concern for SARS are value mismatches disguised through artificial subscription prices. More specifically, the explanatory memorandum states that:

"These structured arrangements involve a creditor that is an unrelated creditor subscribing for shares in the debtor company. The subscription price would be equal to the total amount of the borrower's indebtedness to the creditor in spite of the market value of the shares of the borrower. This subscription price gets paid to the debtor in cash and the debtor then uses the cash to settle the capital of and the interest on the loan or debt. Soon after the payment is effected, the original shareholder of the debtor will buy the shares [of] the creditor. The creditor will (if at all) only be subject to CGT on a very small gain in respect of the shares in the debt sold to the shareholder."

We believe that this example is very helpful in understanding the concern. Given the above, it appears that the issue could be restated via the following example:

<u>Example – Facts</u>: Parent Company owns all of the shares of Subsidiary. Subsidiary has R8 million of assets and has liabilities of R15 million, of which R12 million is owed to Independent Bank. In order to eliminate much of this debt, Subsidiary issues a new set of shares to Independent Bank at a stated subscription price of R12 million. Subsidiary then uses the R12 million to fully pay of the bank. Bank subsequently sells the shares back to Parent Company.

<u>Outcome</u>: The value of the shares issues are worth far less than the subscription price. The value of Subsidiary is only worth R5 million (R8 million gross assets less R3 million remaining debt) even after the Bank repayment. The concern for SARS is that the Bank effectively cancelled R12 million debt for share consideration of only R5 million.

In essence, the anti-avoidance rules of section 19B are seeking to ensure that the tax on the straight cancellation of debt are not circumvented via a share-for-debt swap, followed by an artificial full repayment of debt to the creditor.

b. Suggested solution

We believe that the share-for-debt mismatch can be eliminated without eviscerating the current system of group company relief. The real problem is that the share-for-debt swap of concern is not an equal value-for-value exchange and that the stated subscription price is not a proper reflection of value. Under example of the explanatory memorandum, the existence of group shareholder is irrelevant.

Given this mismatch, we would suggest the better remedy is to revise section 24BA and scrap the proposed section 19B in its entirety. Section 24BA is specifically designed to trigger tax when shares are issued for assets when the shares and assets are not of the same value. Tax is triggered if the assets contributed exceed the value of the shares and if the share value exceeds the value of the assets.

We would accordingly suggest that section 24BA be extended to cover share mismatches involving debt (and even cash). Under this approach, share value that falls below the debt cancelled should trigger tax under section 24BA. The stated subscription price would be wholly disregarded. This excess should be treated as a gain for the company receiving the excess value (see section 24BA(3)(a)). Under debt rescue scenario's, however, we would recommend that the shortfall of the share value under the debt cancelled should be used as a "reduction amount" and that the normal debt relief provisions in section 19 and paragraph 12A should apply.

4. Recoupment of interest associated with intra-group debt if paid with shares (section 19A)

a. Background

It is proposed that the conversion of debt to equity in a group scenario will not trigger the debt reduction rules, but will, effectively be accepted as a method of repayment of the debt (subject to point 3 above). The proposal is aimed at achieving the outcome that would have been achieved had the creditor originally funded the company by means of equity rather than a loan. It is, therefore, proposed that the interest claimed by the borrower should be recouped if the lender was not subject to income tax on the interest income. This could mean that even if the lender was subject to interest withholding tax, the interest would be recouped by the borrower.

b. Suggested solution

The provision should not apply if the interest is subject to cross-border withholding (after taking tax treaties into account) even though the foreign creditor is not subject to normal tax on the interest. The withholding tax in many cases can exceed the taxable net income associated with the receipt / accrual of interest.

Where the interest deduction has contributed to assessed losses, which have subsequently been forfeited because the debtor has ceased trading, we are of the view that such losses should be available to shield the interest recoupment.

We also note that the timing of the group relationship in respect of the debt is unclear.

5. New Dormant Company Rule (Section 19(8)(e) / Paragraph 12A(d)(6))

a. Background

The proposed legislation seeks to provide specific relief for intra-group debt cancellations in the case of dormant debtor companies. For a company to be viewed as dormant, the company must nor carry on a trade, have no receipts / accruals, have no assets and have no liability incurred or assumed. These activity limitations must remain in place for at least three years preceding the debt cancellation. This relief is the one new rule in favour of distressed companies seeking debt relief proposed by the Bill.

b. Suggested solution

The level of activity required to determine dormancy is excessive in practical terms. While we agree that the dormant company at issue should not be allowed to engage in a trade, dormant companies often have residual assets, liabilities, income and expense during the dormancy period after years of activity. These companies may hold a final set of difficult assets to sell, receive cash from unanticipated sources stemming from prior active years and frequently incur liabilities due to final legal, accounting and other administrative expenses associated with the final termination of the dormant company. For instance, the “dormant” company may continue to prepare Annual Financial Statements and Tax Returns and would maintain its company registration. Debtors may settle amounts owing to the company or the company may receive a tax refund.

Hence, the test for dormancy should only focus on the existence of a trade. Alternatively, final wind-down activities should simply be ignored.

6. Debt Cancellations in the Case of Mining Companies (Section 36(7E)

a. Background

Current law does not adequately cater for mining capital expenditure not yet taken into account as a deduction. It is now proposed that the cancellation of debt initially used for mining capital expenditure be applied to reduce mining capital expenditure not yet taken into account as a deduction. Excess debt beyond this expenditure gives rise to ordinary revenue.

b. Suggested solution

The amendment does not adequately address the treatment of debt foregone which was used to finance multiple mining assets located in separately ring-fenced mines. The debt cancellation appears to exist as a simple aggregate. In other words, can debt cancelled in respect of capital expenditure incurred in terms of one mine be used as a non-taxable offset in respect of another mine or can all debts and capital expenditures be treated as a single aggregate for this purpose?

7. Debt cancellation effective dates

a. Background

Sections 19 and 19B as well as paragraph 12A of the 8th Schedule come into operation on 1 January 2018. No effective date is given for section 19A. These effective dates, however need further precision as to the actual trigger.

b. Suggested solution

We recommend that the provisions explicitly state that the amendments come into operation on 1 January 2018 and apply to the issue of shares, debt cancellation and other similar disposals on or after that date.

D. FINANCIAL SECTOR CHANGES

1. Lack of Alignment to IFRS for Key Banking Transactions (Sections 11(jA) and 24J)

a. Background

The proposed legislation makes significant changes to instruments held by banks. The proposed legislation removes the alternative method for calculating interest deductions under section 24J under the stated reason that South Africa no longer applies GAAP. The proposed legislation also provides objective rules for claiming deductible impairments on bank loans.

We believe these changes need to be reconsidered as a matter of tax policy and administration. As recognised by the explanatory memorandum, banks are highly regulated with IFRS accounting having a real impact on the calculations leading to those regulations (such as the bank solvency requirements. Therefore, IFRS accounting represents a true reflect of net economic income that lies at the core of the income tax system. It also anomalous for regulator reserves to be based on one set of calculations while tax is based on another. This form of incongruity was specifically eliminated for short-term insurers in terms of their reserves and lies at the heart of many of the tax changes regarding the derivatives held by banks.

b. Suggest solution

Our position is that the bank tax rules should generally follow IFRS for impairments and for the section 24J interest calculations. Reliance on IFRS is not something that be easily manipulated. Banks are listed companies wherein IFRS is utilised as the key measure for accounting to shareholders. More importantly, banks are highly regulated by the Reserve Bank and internationally in terms of their lending requirements, especially in terms of their solvency ratios. Again, IFRS is a key point of analysis for this regulation.

We understand that SARS may be reluctant to apply IFRS for impairments due to the potential loss of revenue. That said, these rules are about fairness and economic efficiency – not solely about raising revenue targets. We are also concerned that over-taxation of impaired loans may lead to a further aversion against risk-taking in terms of riskier loans because the banks won't obtain an appropriate level of deductions for doubtful debts, thereby added to the cost of troubled loans.

c. Non-Banking Financial Institutions

We lastly note that many of the rules for formal banking institutions do not currently apply to other lenders, many of whom are also fairly regulated. These lenders would include licenced Financial Service Providers (FSP's) who engage in the business of providing retail and commercial funding to customers (e.g. automotive finance companies). Query whether some of the financial instrument rules for banks could be extended to these non-bank lenders.