South African Institute of Tax Professionals

26 August 2019

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RE: DRAFT TAXATION LAWS AMENDMENT BILL, 2019

We have attached the comments from the SAIT Business Transactional and Finance Tax Work Group on the draft Taxation Laws Amendment Bill (draft TLAB) pertaining to the transactional and finance tax issues contained in the bill (e.g. dividend stripping, rollovers and debt-financed share acquisitions). We appreciate the opportunity to participate in the process and welcome further dialogue.

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

Yours sincerely

The SAIT Business Transactional and Finance Tax Work Group

All references are to the Income Tax Act, No. 58 of 1962 (the ITA), unless otherwise indicated.

BUSINESS TRANSACTIONAL AND FINANCE TAX WORKGROUP

1. Further Closure of Anti-Dividend Stripping Schemes (Section 22B and Paragraphs 43A of the 8th Schedule)

Government Proposal

For the last few years, Government has been seeking to prevent the artificial conversion of taxable sales of target subsidiary shares by company sellers into tax-free dividends. These efforts have resulted in a series of anti-dividend stripping rules, which have closed most of these schemes. However, certain dividend stripping schemes remain. In most of the prior schemes, the company seller eliminates its position via a target subsidiary issue of shares to the buyer, followed by a target subsidiary buyback of its shares from the company seller.

In the scheme outstanding, there is no buyback, but the company's seller's share interest is effectively rendered meaningless.

Example: Company X owns all 1 000 ordinary shares of Target Company when the value of Target Company is worth R40 million. Company Buyer plans to purchase Target Company from Company X indirectly for R40 million. Target Company distributes a R40 million dividend on loan account, leaving Target Company with a net value of zero. Company 2 transfers R40 million to Target Company in exchange for 40 million ordinary shares. Target Company pays the R40 million cash to Company X to cancel the loan account. Company X retains its de minimis shares (having only 1 000 out of 40 001 000) with a proposed buyback sometime in the future safely beyond the anti-avoidance period.

Government currently seeks to close this loophole by creating a deemed disposal whenever a company issues shares and that share issue reduces the effective interest of shares held by pre-existing company shareholders of the issuing company. The deemed disposal will fall on the pre-existing company shareholders. The deemed disposal equals the percentage reduction in effective interest.

Workgroup Comment – Problem with the Effective Interest Test

The reduction in "effective interest" test goes too far because any issue of shares by a company could be viewed as an effective reduction of interest for the pre-existing shareholders. The term "effective interest" could easily be viewed to mean relative interest in terms of the overall shares outstanding.

Example. Company Shareholders 1 and 2 each own 100 ordinary shares in Company X, which is worth R30 million. Company X issues an additional 100 ordinary shares to Company 3 in exchange for R15 million in cash (so Company X is now worth R45 million).

In this example, Company Shareholders 1 and 2 each have had a reduction of "effective interest" from a 50% interest down to a 33% interest. However, the value for each of Company Shareholders 1 and 2 remain at R15 million each. There is no deemed sale.

The real problem Government is seeking to address is the "dividend stripping", not the new share issue. Any new share issue always reduces the overall percentage of shares held by pre-existing shareholders without regard to any further step.

There comes a point when a dividend is so large that the dividend effectively amounts to "capital distribution" for the company. In the cases of concern, the dividends amount to 100 per cent of the total value of the target company. Government may want to instead target dividends that equal 80 per cent or more of the value of the distributing company as an automatic capital distribution.

Other problems with the effective interest test relate to the denominator. When one measures "effective interest", is the measurement based on all shares outstanding or on a class-by-class basis. One concern is that the straight issue of preference shares (especially if more akin to debt) automatically trigger a reduction in "effective interest".

Lastly, if capital gains are to be triggered for pre-existing shares, some have suggested that the pre-existing shareholders should have a base cost bump up in their shares so that gain is not taxed twice.

Workgroup Comment – Pre-Existing Concern

We again reiterate that the initial anti-avoidance legislation is far too broad in terms of buy-backs. The current legislation effectively treats the buyback of all company shares as a capital gain event regardless of any further steps. A buyback by itself does not create a problem, especially when the value of the shares repurchased represents a minority of shares. In practical terms, the current anti-avoidance legislation even impacts BEE-owned company shareholders.

Example: Parent Company owns 70 per cent of the ordinary shares of Operating Company. The other 30 percent are held by Holdco representing a BEE consortium. If Operating Company merely redeems the shares held by BEE Holdco without more, the anti-avoidance legislation is triggered (because the technical "dividend" simultaneously triggers a "disposal"). The net result is a CGT tax charge on BEE transactions that was not initially planned, resulting in a major unanticipated loss for BEE shareholders.

Again, a mere buyback of shares held by a company should not be viewed as an avoidance transaction. The buyback is only a problem when other new shareholders are being simultaneously introduced or possibly when the overall of the overall payout to the distributing company is so large as to amount to a capital distribution (i.e. a redemption of all or more pre-existing shareholders).

We again request that the initial anti-avoidance legislation be revisited with urgency. The current anti-avoidance legislation goes too far and is having an unfair impact on legitimate buybacks.

2. Clarification of Rollover Relief for Foreign Currency Gains / Loss (section 24I) and for Debt (section 24J)

Government Proposal

Government has determined that it is unclear whether the current reorganisation rollover relief applies to currency gains and losses (section 24I) and / or to section 24J debt instruments. Government accordingly is clarifying that rollover relief will not apply to these items.

Workgroup Comment

The workgroup totally disagrees with the proposed change. The group see no policy reason for excluding these items from reorganisation relief. Gains and losses from these items are no less deserving of rollover relief than other forms of gain / loss as a theoretical matter.

The workgroup is especially concerned about the lack of relief for foreign currency gains and losses, especially in relation to deferred amounts under section 24I(10). The whole purpose of rollover relief is to defer gain /loss when the transfer does not involve a transaction resulting in cash to pay tax. South African currency has been especially volatile in the last number of years giving rise to substantial changes in relative values.

We informally understand that the need for clarification may have stemmed from the SARS rulings unit. We again believe that the clarification should be in favour of including the relief as was intended when the corporate rollover rules were initially devised. We further understand that there may be a technical problem in applying some of these instruments to certain 18-month and other anti-avoidance rules within the reorganisations. If so, it should be clarified that these gains / losses should be fully within the reorganisation rollover rules, including all anti-avoidance rules contained therein.

3. Clarifying the Impact of Deferred Tax When Applying the Value-Shifting Rules for Asset-for-Share Transactions (Section 24BA)

Government Proposal

Certain anti-avoidance rules exist to prevent asset-for-share transactions from being used as a means of artificially shifting value. However, these rules create potential anomalies when the value of the shares issued differed from the value of the assets transferred without regard to a shift in value between the role players. One such value change stems from the difference in values caused by accounting. The tax cost of certain assets often differs from the accounting cost because both tax and accounting have different write-off periods.

The net result is that the shares issued may have a different value than the value of the assets transferred in exchange due to the inherent deferred tax liability created. This form of value shift was never intended to be viewed as abusive and is inherent in any asset-for-share exchange. The proposed bill accordingly excludes this form of value change from the anti-avoidance legislation.

Workgroup Comment

The intention of the amendment is fully supported. The only concern relates to the accounting recognition of the parties. Not all companies will formally recognize deferred tax liabilities on their books even though this deferred tax liability impacts value. Hence, the words “determined in terms of International Accounting Standard 12 of IFRS” may be too formal. The key is the existence of the deferred tax liability – not whether it is recognised on the company books. The above words should accordingly be dropped or clarified.

We also note that section 24BA has other unintended anomalies that need to be addressed that commonly arise in many asset-for-share transactions. For instance, the some of the parts may be less than the whole. When forming a business, the newly formed company may have a value than the sum of the assets contributed. For instance, assume Individuals A and B contribute asset worth R1 million each in exchange for 50 shares, the net value of the company may be worth R2.2 because the whole is worth more than the parts. This type of value enhancement should also not trigger a section 24BA tax event. For a more detailed description of the value anomalies within section 24BA, we would advise that you refer to an article by Ernest Mazansky in the “Taxpayer” magazine (called “EXACTLY HOW IS SECTION 24BA OF THE INCOME TAX ACT TO BE APPROACHED?”)

4. Deduction for Interest in Terms of Share Acquisitions (Section 24O)

Government Proposal

Under section 24O, taxpayers can deduct interest on debt used to fund the acquisition of shares of a target operating company. The rule equally applies when the operating company is held through a target holding company (or within the target company group). The standard for interest deductibility is applied on annual basis.

Technical problems arise when the operating company moves within a group of companies but remains with the acquiring company's direct or indirect control. More particularly, the wording appears problematic when the operating company moves under direct acquiring company control via an unbundling. The proposal accordingly seeks to specifically allow for the interest deduction to continue when the operating company moves from indirect to direct control.

Workgroup Comment

The proposed amendment is appreciated, but we are confused about the movement of the 90% proviso in subsection (3). In particular, why was the 90 per cent proviso moved from (3)(b) to cover all of subsection (3) (i.e. to include (3)(a)?

Paragraph 3(a) has no relevance to value – only whether the company qualifies as an operating company. Perhaps, the goal relates to concerns where the operating company holds shares in another operating company but that would make little sense since the operating company and "other company" (i.e. holdco rules) are clearly delineated. Another related question for the 90% test is when the test is to be applied (on acquisition or on an annual basis)? [Seems to be annual.]

End.