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CONTENTS

South Africa

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Overview of corporate tax work

The corporate tax work of the past year has been mixed. There have been a number of corporate restructuring transactions, refinancing of debt push down transactions and a number of transactions involving share repurchases by companies as a means of enabling shareholders to exit companies. We have also seen an increasing number of enquiries by the South African Revenue Service ("**SARS**") based on the General Anti-Avoidance Rules.

Significant deals and highlights illustrating aspects of corporate tax

As stated above, there have also been a number of transactions involving share repurchases by companies as a means of enabling shareholders to exit companies. The share repurchase became a favoured way of exiting a company, particularly for South African resident company shareholders, where the proceeds of the share repurchase were treated as a dividend for the purposes of the Income Tax Act ("**ITA**"). The motivation behind this seems to have been, in part, the fact South African resident companies are not subject to Dividends Tax. In addition, dividends paid by South African resident companies are generally not subject to income tax or capital gains tax. This enabled shareholders to dispose of their shareholding without paying tax on the proceeds. As will be seen below, the tax authorities have identified these types of transactions for possible inclusion in the list of transactions that must be reported in terms of the Tax Administration Act No. 28 of 2011 ("**Tax Administration Act**").

Key developments affecting tax law and practice

In our view, the key developments affecting South African tax law and practice in the past year have been: (a) the introduction of provisions targeting avoidance schemes involving debt that has equity features; and (b) the introduction of provisions targeting base erosion and profit shifting ("**BEPS**").

<u>Provisions targeting debt with equity features</u>

Section 8F

In the chapter that appeared in the first edition of this publication, we discussed a proposal contained in the Draft Taxation Laws Amendment Bill of 2012 targeting avoidance schemes involving debt which had equity features. The proposal has now become law. It is contained in the new section 8F of the South African Income Tax Act ("**ITA**") which came into effect on 1 April 2014 and applies in respect of amounts incurred on or after 1 April 2014.

The section treats interest which is incurred by a company during a year of assessment **("Tax Year**") in respect of a hybrid debt instrument as a dividend *in specie* declared and paid by the company on the last day of its Tax Year. Treating the amount as a dividend *in specie* has two consequences for the company; firstly, the company becomes liable for a 15% Dividends Tax on the interest and, secondly, it is not entitled to a deduction of the amount.

An instrument (interest-bearing arrangement or debt) qualifies as a hybrid debt instrument if:

- it entitles or obliges the company (debtor or issuer) to convert or exchange the instrument or any part of it to or for shares. It is not a hybrid debt instrument if the market value of the shares into which, or for which it may be converted or exchanged, is equal to the outstanding amount at the time of the conversion or exchange;
- the obligation to pay an amount in terms of the instrument is conditional upon the solvency of the company, i.e. the market value of the company's assets not being less than the market value of its liabilities; or
- the amount owing in terms of the instrument is owed to a connected person and the company is not obliged to redeem the instrument within 30 years from the date of its issue or from the end of the Tax Year.

The section contains a carve out for debts owed or instruments which constitute a tier 1 or tier 2 capital instrument referred to in the regulations issued in terms of section 90 of the Banks Act, issued by a bank as defined in section 1 of the Act or a controlling company in relation to a bank.

<u>Provisions targeting BEPS</u>

Background

The history of these provisions goes back to June 2011, when the South African authorities introduced an emergency amendment to the ITA. Around that time, SARS and the National Treasury Department made a joint media announcement in which it was stated that section 45 of the ITA (which deals with intra-group transactions) would be suspended for an 18-month period. The purpose of the suspension was stated to be the closure of a mechanism in the section which allowed it to be used as a tax-free mechanism to obtain interest deductions which were linked to excessive debt. According to the statement, tax leakage from excessive debt was a global phenomenon and various countries were introducing measures to control interest deductions on excessive debt. The announcement was followed by consultations between SARS, National Treasury and interested parties. The outcome of the consultation process was the introduction of section 23K into the ITA. It was made clear at the time that the section was intended to be a short-term solution to the problem of excessive debt whilst accommodating the needs of the business community.

Section 23K

Section 23K fell away with effect from 1 April 2014. Its effect was to limit the deduction of interest incurred by a company in respect of debt that was issued, assumed or used directly or indirectly to finance the acquisition of an asset in terms of a reorganisation transaction or a debt that was issued, assumed or used to finance the acquisition of a share in terms of an acquisition transaction, or debt which refinanced or substituted debt which financed an acquisition in terms of a reorganisation or acquisition transaction. The section achieved its objective by granting SARS a discretion to issue a directive, upon application by an acquiring company, regarding the extent to which interest incurred by the acquiring company may be deducted. In exercising the discretion, SARS was required to take account of the amount of interest incurred by the acquiring company and all amounts of interest incurred, received or accrued in respect of all debts issued, assumed or used to fund debt which funded the relevant transactions. SARS could only issue a directive permitting the deduction of interest if it was satisfied that the issuing of the directive would not lead nor be likely to lead to a significant reduction of the aggregate taxable income of all parties who incur, receive or accrue interest. The effect of section 23K was that interest deductions associated with this debt were subject to discretionary limits as determined by SARS.

As stated above, section 23K fell away with effect from 1 April 2014. In terms of amendments made to the section, which were introduced by the Taxation Laws Amendment Act of 2013, the provisions of section 23K which limit the deduction of interest do not apply to interest incurred by an acquiring company in terms of: (a) a debt that was issued, assumed or used to fund a reorganisation transaction entered into on or after 1 April 2014; (b) a debt that was issued to redeem, refinance, substitute or settle, on or after 1 April 2014, a debt that funded a reorganisation transaction that was entered into on or after 3 June 2011 and on or before 31 March 2014; (c) a debt that was issued, assumed or used in terms of an acquisition transaction entered into on or after 1 April 2014; or (d) a debt that was issued, assumed or used, on or after 1 April 2014, to redeem, refinance, substitute or settle a debt that funded an acquisition transaction that was entered into on or after 1 January 2013 and on or before 31 March 2014. Section 23K is also excluded in respect of a debt if a directive was issued in respect of the interest in terms of section 23K.

Two sets of rules have been introduced into the ITA to replace the discretionary system introduced by section 23K and these are contained in section 23M and 23N of the South African ITA. The proposal to introduce these provisions was announced by the Minister of Finance in the 2013 budget speech that was delivered on 27 February 2013. Section 23N came into effect on 1 April 2014. Section 23M will only come into effect on 1 January 2015. Section 23M will limit the deduction of interest incurred in respect of debts which are owed to creditors which are not subject to tax in South Africa, and section 23N applies to limit the deduction of interest which is incurred in respect of debts which finance reorganisation and acquisition transactions.

Section 23N

Section 23N came into effect from 1 April 2014 and applies in respect of interest incurred by an acquiring company in terms of: (a) a debt issued, assumed or used to fund a reorganisation transaction entered into on or after 1 April 2014; (b) a debt issued, assumed or used to redeem, refinance or settle a debt which funded a reorganisation transaction entered into on or after 1 April 2014; (c) a debt issued, assumed or used to redeem, refinance or settle , on or after 1 April 2014, a debt which funded a reorganisation transaction entered into on or after 3 June 2011 and on or before 31 March 2014; (d) a debt issued, assumed or used to fund an acquisition transaction entered into on or after 1 April 2014; (e) a debt issued, assumed or used to redeem, refinance or settle a debt which funded an acquisition transaction entered into on or after 1 April 2014; and/or (f) a debt issued, assumed or used, on or after 1 April 2014, to redeem, refinance or settle a debt which funded an acquisition transaction entered into on or after 1 January 2013 and on or before 31 March 2014. Section 23N applies subject to 23M, which means that debt incurred between persons in a controlling relationship will be dealt with in terms of section 23M instead of in terms of section 23N even if it was incurred in respect of a reorganisation or acquisition transaction.

Section 23N defines a "reorganisation transaction" as an intra-group transaction as defined in section 45 of the ITA and a "liquidation distribution" as defined in section 47 of the ITA. It defines an "acquisition transaction" as any transaction in terms of which an acquiring company acquires any equity share in an acquired company that is an operating company and as a result of which the acquiring company, as at the close of the day of the transaction, becomes a controlling group company in relation to the operating company.

Section 23N sets a ceiling for the deduction of interest. In terms of the section, the interest which may be deducted in a Tax Year in terms of all debts contemplated in the section may not be more than the sum of the amount of interest received by or accrued to the acquiring company and 40% of the amount of adjusted taxable income of the acquiring company determined in the tax year in which the acquisition transaction or reorganisation transaction is entered into, or the amount of interest incurred by the acquiring company, whichever is the highest. The amount must be reduced by the amount of any interest incurred by the acquiring company in respect of any other debts i.e. debts not contemplated in section 23N. The section provides for the adjustment of the percentage of the adjusted taxable income which is taken into account where the average repo rate (the rate at which the South African reserve bank lends to commercial/retail banks) for the tax year in which the amount of interest is determined exceeds 10%.

Section 23N does not apply in the following circumstances:

- in respect of interest incurred in respect of a linked unit in the acquiring company which accrues to a long term insurer, pension fund, provident fund, a REIT or short term insurer which holds at least 20% of the linked units in the acquiring company and linked units, were acquired before 1 January 2013 and if at the end of the previous tax year, at least 80% of the value of the assets of the acquiring company (reflected in annual financial statements prepared in accordance with the Companies Act) is directly or indirectly attributable to immovable property. This exclusion will cease to apply on 31 December 2015; or
- if a directive has been issued by the South African Revenue Service in terms of section 23K of the ITA.

Interest in excess of the ceiling can be carried forward for deduction in a subsequent Tax Year but will be permanently lost after the 6th Tax Year i.e. the Tax Year in which the transaction is entered into and the five Tax Years thereafter. This, it has been stated, is intended to prevent the use of excessive debt mainly to achieve tax savings so that the tax savings become a core element of making the deal viable.

Section 23M

Section 23M will only come into effect on 1 January 2015 and when it does, it will set a ceiling on the amount of interest which may be deducted by a debtor in respect of debts: (a) owed to creditors which are in a controlling relationship with the debtor; (b) debts which are advanced by creditors which are not in a controlling relationship with the debtor but which are funded by a person who is in a controlling relationship with the debtor; or (c) debts which are advanced by creditors which are not in a controlling relationship with the debtor but which are guaranteed by a person which is in a controlling relationship with the debtor. In order for the section to apply, the interest on the debt must not be subject to tax in South Africa, either directly or as a result of the application of the South African Controlled Foreign Company rules.

In terms of the section, the interest which may be deducted by the creditor in a Tax Year may not be more than the sum of the interest received by or accrued to the debtor and 40% of the adjusted taxable income of the debtor. The amount must be reduced by the amount of any interest which is incurred by the debtor in respect of any debts which are not contemplated in section 23M. Provision is made in the section for the adjustment of the percentage of the adjusted taxable income which is taken into account in the calculation, where the average repo rate in respect of a Tax Year exceeds 10%. Any excess interest incurred by debtor is carried forward to the next year of assessment and claimed as a deduction, again subject to the limits imposed by section 23M. Unlike in section 23N, the excess interest is not permanently lost after some time and can be carried forward in perpetuity.

As can be seen from the discussion above, the existence of a controlling relationship between debtor and the creditor, funder or guarantor of a debt is central to the application of section 23M. The rationale for this is explained in the explanatory memorandum accompanying the amendment that introduced the section as follows: excessive interest deductions pose a recurring risk if the creditor and debtor form part of the same economic unit. The terms of the funding instrument are often irrelevant because both parties can freely change the terms to serve the overall interest of the group. As a result, the debt label for these instruments is often driven by tax and other regulatory factors; whereas, loan capital frequently represents equity capital to be repaid only once the debtor is profitable. Section 23M defines a controlling relationship as a relationship between a company and any connected person in relation to that company. Therefore, the threshold for determining the existence of a controlling relationship in the context of section 23M is far lower than the threshold that applies when the corporate restructuring rules contained in sections 41 to 47 of the ITA apply. In the context of those rules, a controlling relationship requires a minimum shareholding of 70% by one company in another company, and shares held by non-resident companies or which are held as trading stock are disregarded.

In terms of an amendment which will come into effect on 1 January 2016, section 23M will not apply to any interest incurred by a debtor in respect of a debt to a creditor which funded the debt with money obtained from a lending institution that is not in a controlling relationship with the debtor and if the interest is calculated with reference to an interest rate which is not more than the official rate of interest plus 100 basis points.

Attractions for holding companies

There have been no developments in tax law or practice which would be of interest to holding companies. The headquarter regime discussed in the first edition of this publication is still in place. However, the uptake by companies has been slow.

Industry sector focus

<u>Oil and gas incentives</u>

There have been significant developments in the tax regime for oil and gas companies. The regime was enacted in 2007 within the ITA under the Tenth Schedule. This regime simplified many of the tax incentives offered under OP26 agreements. Like the original OP26 agreements, the purpose of the Tenth Schedule is to provide incentives for oil and gas exploration and production and to offer stability against future tax changes in relation to oil and gas exploration and production. This is achieved through fiscal stability agreements issued by the Minister.

With effect from 31 March 2013, oil and gas companies pay income tax on taxable income which is attributable to oil and gas income at a rate of not more than 28%. Prior to this change, which was introduced by the Taxation Laws Amendment Act of 2012 but came into effect in March 2013, domestic oil and gas companies paid income tax at a rate of not more than 28% whilst non-resident oil and gas companies which carried on trade in South Africa paid income tax at a rate of not more than 31%. The amendment has resulted in parity in the treatment of resident and non-resident oil and gas companies.

Since the introduction of the Tenth Schedule, an increasing number of oil and gas exploration and production rights are now being granted under the MPRDA. Several transfers among oil and gas producers are also taking place. It is against this background that recent experience has indicated that the Tenth Schedule is giving rise to certain anomalies that distort commercial practices. In order to address these perceived distortions, the following amendments to the Tenth Schedule were introduced in 2013 tax legislation:

- the removal of the Dividend Tax rate differential for holders of oil and gas rights and a reduction of the rate of Dividends Tax in respect of dividends paid by oil and gas companies out of oil and gas income, to zero. Prior to this amendment, dividends paid by an oil and gas company out of amounts attributable to oil and gas income were subject to Dividends Tax at a rate of 5% and dividends paid by an oil and gas company out of amounts attributable to its oil and gas income (if all its oil and gas rights were derived by virtue of an OP26 right) were subject to Dividends Tax at 0%. This amendment is deemed to have come into operation on 1 April 2012, the date on which the Dividends Tax came into effect in South Africa;
- the reduction of withholding taxation in respect of interest payments made by oil and gas companies, to zero. The reduced rate will only apply to interest that is paid in respect of loans applied to fund capital expenditure in respect of exploration and post exploration in terms and in respect of an oil and gas right. This amendment will come into operation on 1 January 2015, the date on which the withholding tax on dividends will come into effect; and
- the introduction of a deeming provision in terms of which any company which holds an oil and gas right during a Tax Year is deemed to be carrying on a trade in respect of that oil and gas right and any expenses and losses incurred by the company in respect of the oil and gas right are deemed to be incurred in the production of the company's income. The rationale for the amendment was that it was unclear whether a company engaged solely in exploration could be viewed as being engaged in a trade, thereby being eligible for deductions under the general deduction formula of section 11(a). Other circumstances could arise where trade may not exist (for instance, where there are cessations and post-production rehabilitation). The amendment came into effect on 1 April 2014 and applies in respect of Tax Years commencing on or after 1 April 2014.

The year ahead

The year ahead will be informed by:

- the coming into effect of the long awaited withholding tax on interest;
- recommendations, if any, made by the Tax Review Committee that was established last year;
- some of the proposals that were made by the Minister in the budget speech delivered on 26 February 2014. The Minister made several proposals. Some of the more interesting proposals will affect the provisions that were introduced last year in relation to preference share structures; and
- developments regarding the reporting of transactions.

<u>Withholding tax on interest</u>

The withholding tax will come into effect on 1 January 2015. The withholding tax, calculated at a rate of 15%, will apply to interest that accrues or becomes due and payable on or after 1 January 2015 to a foreign person. The interest must be from a South African source in order to be subject to the withholding. In terms of the ITA, interest is deemed to be from a South African source if it is incurred by a South African resident, wherever the funds are used, or if it is incurred in respect of funds used in South Africa, regardless of who makes the payment. Certain exemptions to the withholding tax will be available. One of the exemptions provides that a non-resident person (not natural person) is exempt from the withholding tax if it carried on business through a permanent establishment in South Africa and the debt claim in respect of which the interest is paid is effectively connected with the permanent establishment and the foreign person is registered as a taxpayer in South Africa. If the non-resident does not have a permanent establishment in South Africa, the double taxation agreement A between South Africa and the country of residence may reduce the rate at which the withholding tax is levied.

<u>Tax Review Committee</u>

In the budget speech delivered on 27 February 2013, the Minister announced that a review of the South African tax system would be conducted to assess whether the South African tax policy was appropriate to support the government's objectives of inclusive growth, employment, development and fiscal sustainability. The announcement was followed by the establishment of a Tax Review Committee (the "**Committee**") headed by Judge Dennis Davis.

The terms of reference of the Committee were to inquire into the role of the South African tax system in the promotion of inclusive economic growth, employment creation, development and fiscal sustainability. The Committee would make recommendations to the Minister and any tax proposals arising from the recommendations would be announced as part of the normal budget and legislative process. The Committee must evaluate the South African tax system against international trends, principles and practices as well as recent initiatives to improve tax compliance and deal with base erosion, giving specific attention to:

- an examination of the overall tax base and tax burden including the appropriate tax mix between: direct taxes, indirect taxes, provincial and local taxes, with an analysis of the sustainability, in the long-run of the overall tax-to-GDP ratio, and the tax-to-GDP ratio for each of the three major tax instruments, personal income tax, corporate income tax and VAT should be undertaken;
- the impact of the tax system in the promotion of small-and-medium-size businesses, including an analysis of tax compliance costs, the possible further streamlining of tax administration and simplification of tax legislation;
- a review of the corporate tax system with special reference to the efficiency of the corporate income tax structure, tax avoidance (e.g. base erosion, income splitting and profit shifting, including the tax bias in favour of debt financing), and tax incentives to promote developmental objectives; and the average (and marginal) effective corporate income tax rates in the various sectors of the economy; whether the current mining tax regime is appropriate, taking account of the agreement between Government, labour and business to ensure that the mining sector contributes to growth and job creation, remains a competitive investment proposition, and all role players contribute to better working and living conditions and the challenges facing the mining sector, including low commodity prices, rising costs, falling outputs and declining margins, as well as to its current contribution to tax revenues;
- whether the current mining tax regime is appropriate, taking account of various elements of taxation within the financial sector, namely the taxation regime of long

term insurers, the taxation of hedge funds, the taxation of various innovative financial instruments (and the VAT treatment of financial services and VAT apportionment within the financial sector);

- VAT with specific reference to efficiency and equity. In this examination, the advisability and effectiveness of dual rates, zero rating and exemptions would be considered;
- the impact of e-commerce (especially the use of digital delivery of goods and services) upon the integrity of the tax base, in particular upon value added tax and corporate income tax revenues;
- the progressivity of the tax system and the role and continued relevance of estate duty to support a more equitable and progressive tax system;
- an evaluation of proposals to fund, for example, the proposed the National Health Insurance (NHI) and long term infrastructure projects to boost the growth potential of this economy; and
- an evaluation of the legislative process with a view to both enhancing simplicity and ensuring the protection of the tax base and to recommend how to improve the current process.

The Committee will publish its first report during the course of this year and no doubt some of the recommendations made in the report are bound to find their way into the legislation. It will be interesting to see what report says, if anything, about mining and the mining tax regime.

<u>Budget proposals</u>

Ministers made the following proposals, which will no doubt be taken into account in this year's legislative amendments:

- the inclusion, among the exceptions (presumably in the definition of a qualifying purpose) relating to third party backed shares, of the refinancing of third party backed shares which were originally used for a qualifying purpose, i.e. to fund equity acquisitions in operating companies. As currently, the definition of a "qualifying purpose" in section 8EA of the ITA does not include the refinancing of these third party-backed shares and it has been determined that there is no policy rationale for this state of affairs; and
- the inclusion of exploration companies in the definition of an "operating company" in section 8EA of the ITA. The concept of an operating company is central to the application of the anti-avoidance provisions relating to third party-backed shares. As currently drafted, the definition contemplates an actively trading company. Exploration companies fall foul of this definition because their activities do not result in the provision of goods or services for consideration, with the consequence that preference shares issued to acquire equity shares in exploration companies fall foul of the provisions of section 8EA.

<u>Developments regarding the reporting of transactions</u>

The publication of a draft notice by the Acting Commissioner of SARS on 10 April 2014, in terms of which the list of transactions that must be reported in terms of the legislation relating to "reportable arrangements" (section 35 of the Tax Administration Act) is to be expanded caused quite a stir in the South African market because of its ambit. The draft notice identified the following arrangements as having characteristics that may lead to an undue tax benefit and which must therefore be reported in terms of 35 of the Tax Administration Act:

- any arrangement in terms of which a company buys back shares from one or more shareholders for an aggregate amount of at least R10 million, if it (the company) issued or is to issue any shares within 12 months of entering into that arrangement or of the date of any buy-back in terms of that arrangement. It appears that the motivation behind this particular inclusion is that fact that the Dividends Tax legislation and particularly the exemptions provided for in the legislation have created a structuring opportunity for shareholders seeking to exit companies. Where the exiting shareholder is a South African resident company, such a shareholder is able to exit the company by requiring the company to effect a share buy-back and to ensure that the proceeds of the share buy-back are treated as a dividend for the purposes of the ITA, instead of selling the shares directly to a third party. Structuring the exit as a share buy-back ensures that the exiting shareholder exits the company without paying any tax on the proceeds of the share repurchase; because the amount is a dividend for the purposes of the ITA, it is not subject to income tax or Dividends Tax; and
- any arrangement in terms of which a person or persons acquire the controlling interest in a company that has carried forward or expects to carry forward a balance of assessed loss exceeding R20 million from the year of assessment immediately preceding the year of assessment in which the shares are purchased, or expects to have an assessed loss exceeding R20 million in the year of assessment during which the shares are purchased. We suspect that the motivation behind this is that SARS has not had a high success rate in enforcing the anti-avoidance provisions contained in section 103(2) of the ITA, which target avoidance schemes involving the use of assessed losses.

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Alan is ranked by Chambers Global as a leader in his field, and is also ranked by other legal publications, including Best Lawyers, Legal 500, IFLR and Plc. Alan's regular clients include Standard Bank, South African Breweries, Bank of America, Merrill Lynch, Barloworld, PPC, Anglogold Ashanti, Marsh and Ericsson. Recent major transactions that Alan has advised on include acting for Standard Bank on the conclusion of its Bancassurance arrangements with Liberty Life; advising Marsh on the acquisition of the South African and African insurance brokerage business of Alexander Forbes Risk Services; and advising SABMiller Plc and SAB Limited on SAB Limited Zenele Black Economic Empowerment transactions. Alan has advised on the structuring and implementation of numerous significant black economic empowerment transactions in the South African market.
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