TAX

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CAPITALISATION OF SHAREHOLDER LOANS AND SET-OFF

The South African Revenue Service (SARS) published Binding Private Ruling 193 (Ruling) on 15 June 2015, which dealt with the partial capitalisation of a shareholder loan.

The applicant was tax resident and incorporated in South Africa, and was held by a non-resident holding company.

The holding company had previously extended a shareholder loan to the applicant, and at the time of the Ruling an amount of capital and interest remained outstanding.

The shareholder loan was applied by the applicant to fund various things, including tax deductible expenditure and allowance assets.

At the time of the Ruling, the Applicant was unable to service the interest payments on the shareholder loan. The shareholder loan was also excessive in terms of thin capitalisation requirements, and there was a risk that not all interest would qualify for deduction.

It was proposed that:

- the holding company would demand payment of a portion of the capital and interest in respect of the shareholder loan;
- the holding company would subscribe for one ordinary share in the applicant at par value plus a premium, which would equal the portion of the shareholder loan that is required to be paid;
- the holding company's obligation to pay the subscription price for the ordinary share, and the applicant's obligation to pay a portion of the shareholder loan, would be settled by way of set-off; and
- the portion of the shareholder loan that would not be settled would remain outstanding.

Usually in circumstances where shareholder loans are capitalised, there is a concern that the transaction could trigger the debt reduction provisions contained in s19 of the Income Tax Act, No 58 of 1962 (Act) and/or paragraph 12A of the Eighth Schedule to the Act.

Depending on how the loan was applied by the taxpayer, these provisions can result in recoupments and/or the reduction of allowable expenditure for capital gains tax purposes (or an immediate capital gain in certain circumstances).

The uncertainty derives from *Commissioner for the South African Revenue Service v Labat Africa Ltd 74* SATC 1 where it was held that the issue of shares by a company does not constitute expenditure incurred. If a company issues shares in settlement of a shareholder loan, the question then arises whether the company has actually settled the loan or whether the loan was waived (or otherwise reduced). However, the court in the Labat case did indicate that it may be possible to structure a transaction so that set-off applies between the obligation of a subscriber to pay the subscription price for a share and any obligation that the issuing company might have towards the subscriber.

In this Ruling SARS ruled that the proposed transaction would not trigger the application of s19 of the Act, paragraph 12A of the Eighth Schedule to the Act, or paragraph 20(3)(b) of the Eighth Schedule to the Act.

SARS also specifically confirmed that the obligations of the parties would be settled by way of set-off.

This is contrary to previous rulings given by SARS (such as Binding Private Ruling No 173), in which SARS insisted that cash would need to flow between the parties in respect of settling their obligations to each other.

This Ruling is important because:

- it again emphasises that loans can be capitalised without necessarily triggering the debt reduction provisions; and
- it confirms that transactions can be structured in such a manner that the obligations between parties are settled by way of set-off, and that it is not necessary for cash to flow.

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AWARDS FROM FOREIGN TRUSTS

The South African Revenue Service (SARS) published Binding Private Ruling No 197 (Ruling) on 1 July 2015. The Ruling dealt with the receipt of funds from a foreign trust, and the subsequent donation and investment thereof.

The applicant was an individual resident in South Africa. The applicant was also a beneficiary of a foreign trust. The foreign trust only held funds sourced from outside South Africa.

The trustees of the foreign trust resolved to award a specified amount of the foreign trust funds to the applicant, after which the applicant would be removed as a beneficiary.

The funds so awarded would be transferred to the applicant's foreign bank account, after which the applicant would:

- donate some of the funds to certain individuals; and
- invest the balance in a property outside South Africa.

Firstly, SARS ruled that the award of the funds by the foreign trust would not be subject to income tax in the hands of the applicant. Unfortunately SARS did not elaborate on the issue, but it appears that the amount awarded to the applicant would not have fallen within the ambit of s25B(2A) of the Income Tax Act, No 58 of 1962 (Act), and would simply be treated as a capital receipt.

Secondly, SARS ruled that the anticipated donations would be exempt from donations tax because of the exemption contained in s56(1)(g)(ii) of the Act. This provision applies where the property that is being donated constitutes a right in property situated outside of South Africa (such as the foreign funds), and it was acquired by the donor *"...by inheritance from a person who at the date of his death was not ordinarily resident in the Republic or by a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic..."*

Unfortunately the Ruling does not reveal whether the foreign trust was a testamentary trust and whether the award of the foreign funds was seen as having been acquired by way of inheritance. The Ruling also does not specify whether the award by the foreign trust was seen as a donation by a non-resident donor.

Thirdly, SARS ruled that the balance of the award, which would be used to acquire a foreign property, would not be included in the estate of the applicant for estate duty purposes because of the application of s4(e)(ii)(aa) or (iii) of the Estate Duty Act, No 45 of 1955.

The said provision excludes any right to property situated outside of South Africa acquired by a deceased:

> *"(ii) after he became ordinarily resident in the Republic for the first time, by:*
>
> *(aa) a donation if at the date of the donation the donor was a person (other than a company) not ordinarily resident in the Republic; or*
>
> *(bb) inheritance from a person who at the date of his death was not ordinarily resident in the Republic; or*
>
> *(iii) out of the profits and proceeds of any such property proved to the satisfaction of the Commissioner to have been acquired out of such profits or proceeds..."*

Again, the Ruling is not specific as to whether the award is seen as an inheritance or a donation.

It was also specifically noted in the Ruling that SARS would not rule on whether the proposed transaction formed part of any arrangement for the avoidance of tax.

SARS indicated that the Ruling would be valid for a period of approximately ten years, but it is submitted that, since the Ruling concerned the application of the Estate Duty Act at the time of the death of the applicant, it should have been extended until such time.

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