DLA CLIFFE DEKKER HOFMEYR

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TAX ALERT

EXCHANGE CONTROL: *OILWELL* DOES NOT END WELL

South Africa (SA) imposes exchange controls. Recently, the policy and practice of the SA government has been to relax these controls. I welcome this trend: I think exchange controls frustrate foreign investors and limit unreasonably the rights of SA residents to trade. So it is regrettable when the government reverses this trend.

Exchange controls are governed by the rules and regulations issued under the Currency and Exchanges Act, No 9 of 1933. The SA Reserve Bank administers the controls.

An important rule is that a SA resident may not export 'capital' without approval from the SA Reserve Bank.

A year ago, in the case of *Oilwell (Pty) Limited v Protec International Ltd & others 2001 (4) SA 394 (SCA)*, which involved the transfer of intellectual property rights by a resident to a non-resident, the Supreme Court of Appeal held that the term 'capital' in this context must be interpreted restrictively to mean cash and money; the term must not be interpreted to include goods, in particular, intellectual property rights. (For more on that case, see our Tax Alert of 25 March 2011, which can be found by clicking here.)

However, the SA government has now by presidential *fiat* overturned certain aspects of the *Oilwell* ruling. From 8 June 2012, the President changed the exchange control regulations by inserting a new Regulation 10(4) which reads as follows:

> "(4) For the purpose of sub-regulation (1)(c) –
>
> (a) 'capital' shall include, without derogating from the generality of that term, any intellectual property right, whether registered or unregistered; and
>
> (b) 'exported from the Republic' shall include, without derogating from the generality of that term, the cession of, the creation of a hypothetic or other form of security over, the assignment or transfer of any intellectual property right, to or in favour of a person who is not resident in the Republic."

One effect of the change is that SA residents who wish to, say, sell and transfer intellectual property rights in SA like trademarks, copyright and patents to non-residents must obtain exchange control approval. Similarly, any non-resident who wishes to obtain security over intellectual property rights in SA must obtain approval.

What are the implications if approval is not obtained? What is clear is that the SA resident will be committing a crime and, among other sanctions, may be fined.

What, however, is still not clear is what the implications are as between the parties to the transaction. In the *Oilwell* case, the court held that a transaction that falls foul of a prohibition in the exchange control regulations is not invalid. The court however, further held as follows:

"This does not mean that in the absence of Treasury consent the transaction is enforceable without more. Parties who enter into a contract that may conceivably be hit by the Regulations are, unless the contract provides otherwise…, both obliged to take the necessary steps to obtain The Treasury's consent (something expressly agreed to by the parties). This must be so because of the supposition that the parties negotiated in good faith and intended to enter into an effective contract. There is nothing preventing The Treasury from consenting to a transaction *ex post facto*. This means that the transaction absent consent is not void at the behest or election of one of the parties to it. A party faced with a claim based on a transaction which that party believes is covered by the Regulations can therefore not rely only on the lack of consent to avoid the claim. The defendant may in appropriate circumstances file a dilatory plea pending the determination by The Treasury of its application for the necessary consent. Once The Treasury refuses to grant consent, the defendant would be entitled to resist the claim on that ground. If performance took place without consent, neither party may claim restitution. It would then be for The Treasury to invoke [the applicable Regulations] to undo the effect or proposed effect of the transaction." (Footnotes are omitted.)

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As two commentators have pointed out, the decision of the court in this respect is contradictory "in that the non-automatic enforceability of an agreement for which approval was not obtained could force a party into a position where she in any event must seek approval": (Max du Plessis and Stephanie Luiz *Going offshore*: *The assignment of a trade mark and the meaning of 'capital'*: Oilwell (Pty) Ltd v Protec International Ltd, *The South African Law Journal* Vol 129 Part 1).

Again, it is unfortunate that the SA government has felt it necessary to extend its exchange control 'tentacles' (to use the word of the commentators referred to above). In my view, speaking as a lawyer, exchange controls should be abolished, once and for all.

Ben Strauss

DISPOSAL OF A RESIDENCE FROM A COMPANY OR TRUST: MULTI-TIERED STRUCTURES

SARS recently released the second issue of its guide dealing with the window of opportunity (covering the period 1 October 2010 to 31 December 2012) for the disposal of a residence from a company, close corporation or trust into the hands of qualifying individuals. When carefully structured, these transactions will be free of transfer duty, capital gains tax and dividends tax (formerly secondary tax on companies).

A hotly debated topic is the question of who must acquire the residence, particularly in the context of a multi-tiered structure. An example of a multi-tiered structure is where a trust holds the shares in a company which in turn holds a residence. Paragraph 51A(6) of the Eighth Schedule to the Income Tax Act, No 58 of 1962 (Act) identifies the ultimate acquirer of the residence as the natural person(s) referred to in paragraph 51A(1)(b), namely the person(s) who:

- Used the residence mainly for domestic purposes from 11 February 2009 until the date of acquisition by them of the residence; and
- Are connected persons in relation to the company or trust at the time of disposal.

The conventional way of effecting a transfer of the residence in the said example is for the company to dispose of the residence to the trust (its shareholder), which in turn disposes of the residence to a qualifying natural person, that is to a natural person who used the residence mainly for domestic purposes from 11 February 2009 until the date of acquisition by them of the residence <u>and</u> who is a connected person in relation to the trust. In this regard, every beneficiary of a trust is a connected person in relation to the trust as well as any person who is a connected person in relation to such beneficiary. A founder or trustee of the trust could qualify as a connected person in relation to the trust if such person is, for example, a spouse of a beneficiary or someone related to a beneficiary within the second degree of consanguinity (blood relationship). Typically, this would include a parent, grandparent, sibling, child and grandchild.

If the residence is transferred in this conventional way it is a further requirement that the company be liquidated, wound up or deregistered and also that the trust be terminated. The issue that has been raised is that adverse estate duty and capital gains tax consequences often arise on termination of the trust where it holds assets other than the residence (for example shares or a commercial property).

The question is whether it is permissible to dispose of the residence from the company directly to a beneficiary of the trust (that is to bypass the trust) and thus avoid having to terminate the trust.

It is refreshing that in the second issue of its guide SARS takes the view that in a multi-tiered structure it is possible to circumvent the trust under the provisions of paragraph 51A(4) of the Eighth Schedule. According to SARS, unlike paragraph 51A(3) which identifies the acquirer as a shareholder, paragraph 51A(4) arguably does not. SARS states as follows:

'Paragraph 51A(4)(a) requires that the acquirer must disregard the disposal of "any share" in the company upon its termination but does not specifically require that the person must actually hold shares. Arguably this could be inferred. In view of the limited application of paragraph 51A and the fact that one of its purposes is to reduce the number of companies on register, SARS will accept that paragraph 51A(4) does not require a person acquiring a residence from a company to be shareholder.'

A beneficiary of the trust in the multi-tiered example referred to above, will qualify as a connected person in relation to the company by virtue of paragraph (bA) of the definition of a 'connected person' in s1 of the Act. The reason is that the beneficiary is connected to the trust and the trust is connected to the company. So, as long as the beneficiary used the residence mainly for domestic purposes from 11 February 2009 until the date of acquisition by him of the residence, then the requirements of paragraph 51A(6) read with paragraph 51A(1)(b) regarding who may be an ultimate acquirer of the residence will be satisfied.

How then should one go about such a transaction to ensure that no transfer duty, capital gains tax, dividends tax and donations tax is paid?

Firstly, it should be appreciated that paragraph 51A does not specify how the residence must be disposed of by the company or trust, as the case may be, in order to achieve the tax benefits. Nonetheless, it is widely accepted that the transaction could be structured either as a sale of the residence or a distribution thereof as a dividend *in specie* (in the context of a company or close

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corporation) or a capital distribution in the context of a trust. In the multi-tiered example mentioned above, the company will not strictly speaking be able to distribute the residence as a dividend *in specie* as the residence is not disposed of to the trust itself as shareholder but rather directly to a beneficiary of the trust.

If one considers implementing the transaction by way of a sale by the company to a beneficiary, the question that arises, particularly in the context of donations tax, is for what value or purchase price the residence should be sold. It bears noting that there is no specific exemption from donations tax to deal with a donation that may arise in consequence of the disposal of a residence under paragraph 51A.

The immediate reaction is to structure the sale at market value. However, this will result in the company receiving the purchase price which, after the payment of any loan or other liabilities, will be distributed as a dividend either before or in the process of winding up or deregistering the company. Such distribution, being a cash distribution, will trigger the payment of dividends tax by either the trust or a beneficiary of the trust, depending on who can properly be regarded as the beneficial owner of the dividend.

Another possibility is for the company to sell the residence to a beneficiary for below market value. Given the wide ambit of the term 'dividend' in s1 of the Act, a below market value sale by the company to the beneficiary at the instance or on behalf of the trust (as shareholder) will arguably constitute a dividend but will in any event be exempt from dividends tax in terms of s64FA(1)(c) as constituting the disposal of a residence as contemplated in paragraph 51A.

So far so good, but what about donations tax? In terms of s58 of the Act, property is deemed to have been disposed of under a donation where the Commissioner is of the opinion that the consideration therefor is not an adequate consideration. A sale at less than market value will generally constitute inadequate consideration, resulting in a deemed donation of an amount equivalent to the difference between the market value and the actual consideration or purchase price. In this context, s57 will deem the donor to be a person other than the company where:

- a company disposes of property at the instance of any person;
- that disposal would have been treated as a donation had it been made by that person.

The residence will generally be disposed of by the company at the instance of the trust as shareholder. This is so because the trust will be required to consent to the disposal of the residence as constituting the sole or greater part of the assets of the company. In terms of s57 of the Act, the trust as shareholder will be treated as the donor provided that the disposal would have been treated as a donation if it had been made by the trust itself (see the second bullet point directly above). Relevantly, s54 of the Act, the charging section in respect of donations tax, limits the ambit of donations tax to donations made by a resident of South Africa. Thus, where the trust is a resident of South Africa the second requirement under s57 will be met and the trust will be regarded as the donor and donations tax will in principle be payable.

Section 56 which contains a list of exemptions should be considered in turn. Of relevance is s56(1)(l), which provides that no donations tax is payable in respect of any property disposed of under and in pursuance of any trust. This means that the disposal will be exempt from donations tax if it is made to a beneficiary stipulated in and in accordance with the provisions of the trust deed. In summary, the combined effect of s58, s57 and s56(1)(l) will be to treat the trust as the donor in respect of the below market value sale but to exempt the sale from donations tax where a beneficiary of the trust acquires the residence.

A word of caution: if the trust is not a resident of South Africa, the second requirement of s57 is not met, in other words the disposal would not have been treated as a donation in that donations tax is confined to residents of South Africa. The effect is that the company will remain the donor and donations tax will be payable unless another exemption is applicable.

Where the transaction meets the requirements contained in paragraph 51A, any capital gain will be treated on roll-over basis and subject to capital gains tax when the individual subsequently disposes of the residence. Depending on the circumstances, the primary residence exclusion could operate to absorb or reduce the capital gain. The transaction will also not be subject to transfer duty by virtue of s9(20) of the Transfer Duty Act, No 40 of 1949 and to the extent that it represents the distribution of the residence *in specie* will be exempt from dividends tax by virtue of s64FA(1)(c).

From the above analysis, it is evident that one should exercise caution when availing oneself of the potential tax advantages associated with paragraph 51A and the other related provisions. As mentioned, there is no express provision exempting the transaction from donations tax and thus one should not lose sight of the relevant donations tax provisions. In the context of a multi-tiered structure, SARS' view is to be welcomed but each case should be examined on its merits with a full appreciation of the attendant risks.

Although there is no cut-off date by which transfer of the residence is to take place under the amnesty provisions, the date of disposal shall be a date not later than 31 December 2012. It is recommended that those contemplating a transfer in terms of the amnesty provisions obtain specialist advice well before the cut-off date so that all available options can be explored and carefully considered.

Andrew Seaber

CONTACT US

For more information about our Tax practice and services, please contact:

Emil Brincker
Director
National Practice Head
T + 27 (0)11 562 1063
E emil.brincker@dlacdh.com

Alastair Morphet
Director
T + 27 (0)11 562 1391
E alastair.morphet@dlacdh.com

Natalie Napier
Director
T + 27 (0)11 562 1109
E natalie.napier@dlacdh.com

Ben Strauss
Director
T + 27 (0)21 405 6063
E ben.strauss@dlacdh.com

Johan van der Walt
Director
T + 27 (0)11 562 1177
E johan.vanderwalt@dlacdh.com

Ruaan van Eeden
Director
T + 27 (0)11 562 1086
E ruaan.vaneeden@dlacdh.com

Andrew Lewis
Senior Associate
T + 27 (0)11 562 1085
E andrew.lewis@dlacdh.com

Andrew Seaber
Senior Associate
T + 27 (0)11 562 1768
E andrew.seaber@dlacdh.com

Heinrich Louw
Associate
T + 27 (0)11 562 1187
E heinrich.louw@dlacdh.com

Tessmerica Moodley
Associate
T + 27 (0)21 481 6397
E tessmerica.moodley@dlacdh.com

BBBEE STATUS: LEVEL THREE CONTRIBUTOR

JOHANNESBURG

1 Protea Place Sandton Johannesburg 2196, Private Bag X40 Benmore 2010 South Africa
Dx 154 Randburg and Dx 42 Johannesburg
T + 27 (0)11 562 1000 **F** +27 (0)11 562 1111 **E** jhb@dlacdh.com

CAPE TOWN

11 Buitengracht Street Cape Town 8001, PO Box 695 Cape Town 8000 South Africa
Dx 5 Cape Town
T + 27 (0)21 481 6300 **F** +27 (0)21 481 6388 **E** ctn@dlacdh.com

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Cliffe Dekker Hofmeyr is a member of DLA Piper Group,
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