

TAX IMPLICATIONS OF CERTAIN COMPANY DISTRIBUTIONS

The interaction between the tax law and company law rules relating to corporate distributions gives rise to interesting issues.

Consider the following example:

The simplified balance sheet of Company A is the following:

Share capital	R1,000
Retained income	R100
	R1,100
Cash in bank	R1,100
	R1,100

The sole shareholder of Company A is Company B. Both companies are tax residents in South Africa. Company A wishes to make a distribution to Company B in the amount of R250.

Now, if Company A funded the distribution out of share capital, Company B would need to account for capital gains tax (CGT) – see below. However, if Company A funded the distribution out of retained income, the distribution would be a dividend and would be free of income tax or dividends tax in the hands of Company B – see below.

If Company A funded the distribution out of retained income, the simplified balance sheet of Company A after the distribution would be the following:

Share capital	R1,000
Retained income	(R150)
	R850
Cash in bank	R850
	R850

IN THIS ISSUE

- **Tax implications of certain company distributions**
- **Claiming input VAT on professional fees incurred in a takeover**

In other words, Company A will have negative retained income after the distribution.

The question that I address here is whether that course of action is possible. In other words, is it workable for a company to fund a distribution out of retained income if it does not have sufficient retained income but does have sufficient share capital?

The term dividend is defined in s1 of the Income Tax Act, No 58 of 1962 (Income Tax Act), to the extent that it is relevant, as –

"any amount transferred or applied by a company that is resident for the benefit or on behalf of any person in respect of any share of that company, whether that amount is transferred or applied –

(a) by way of a distribution made by;

...

that company, but does not include any amount so transferred or applied to the extent that the amount so transferred or applied –

(i) results in a reduction of contributed tax capital of the company;..."

The term 'distribution' is not defined in the Income Tax Act. I submit that, as the term is used in relation to a company, one should have regard to the definition of 'distribution' in the Companies Act, No 71 of 2008.

The definition of the term 'contributed tax capital' in the Income Tax Act is complex. For present purposes, the contributed tax capital (CTC) of a company is its share capital or stated capital.

Until the end of the previous century, under the capital maintenance rule, a company was only allowed to distribute funds to shareholders from distributable profits. However, now a company is allowed to make any distribution, including a distribution from its share capital, as long as it meets certain requirements, notably the solvency and liquidity test. Put simply, under that test a company may make a distribution if its assets exceed its liabilities and if it will in the near future be able to pay its debts as they arise.

To return to our example above, from a company law perspective (unless its memorandum of incorporation prohibits this) the directors of Company A would be able to make a distribution funded from retained income as opposed to share capital as long as the company meets the solvency and liquidity test.

From a tax perspective, unless the directors determine that the amount of the distribution is funded from CTC, the distribution will not result in a reduction of CTC and will be considered to be a dividend.

In terms of s10(1)(k) of the Income Tax Act a dividend is exempt from income tax, subject to exceptions. In terms of s64F(1)(a) of the Income Tax Act a dividend paid to a tax resident company is also free of the dividends tax. Accordingly, Company B will suffer no tax if the distribution is funded out of retained income.

However, had the directors determined that the distribution was funded from CTC then, while the distribution will not have had immediate CGT consequences, it will have consequences for Company B in future: it will have to add the amount of the distribution to the proceeds when it disposes of the shares in Company A.

Does the above course of action constitute an impermissible scheme to avoid tax? In my view, the answer is no. One of the requirements of the general anti-avoidance provision contained in s80A of the Income Tax Act and further is that the sole or

main purpose of the arrangement must be to obtain a tax benefit. If the company is simply making a distribution to shareholders and choosing to do so otherwise than from CTC, the purpose of the arrangement would not be to obtain a tax benefit – it would be to make a distribution.

However, the position may well be different in the case where such a distribution is done in conjunction with other arrangements such as a sale of shares.

In this context, the following principles and provisions should also be borne in mind.

It is trite that if a company borrows money to pay a distribution to shareholders, the interest on the loan will not be tax deductible as the funds will not be applied in the production of income.

Section 22B of the Income Tax Act and paragraph 43A of the Eighth Schedule to the Income Tax Act attempt to prevent so-called 'dividend stripping'. Put simply, the provisions state that if the shares in a company are being sold; and if that company as part of the sale arrangement borrows money from the purchaser of the shares; and if that company then declares a dividend which is free of taxes in the hands of the seller – then the dividend will have income tax or CGT consequences, as the case may be, for the seller.

Paragraph 19 of the Eighth Schedule is aimed, among other things, at preventing losses that arise on the disposal of shares if the seller received extraordinary exempt dividends (that is, dividends exceeding 15% of the proceeds of the disposal) within an 18-month period preceding the disposal.

It is apparent that making a distribution is not a simple affair, both from a tax law and company law perspective. In particular, companies and their shareholders should obtain advice when a distribution is made in conjunction with another transaction such as a sale of shares.

Ben Strauss

CLAIMING INPUT VAT ON PROFESSIONAL FEES INCURRED IN A TAKEOVER

Judgment was handed down in the Court of Appeal (Civil Division) in the United Kingdom (UK) in the case of *BAA Ltd v Revenue and Customs Commissioners* [2013] EWCA Civ 112 on 21 February 2013. The case dealt with the claiming of Value-added Tax (VAT) paid on professional fees in respect of a takeover transaction.

The facts were as follows:

A consortium was to use a company, being Airport Development and Investments Ltd (ADIL), as a special purpose vehicle to acquire all the shares in an airport operator called BAA plc (BAA). In the course of bidding for the acquisition of the shares, ADIL engaged the services of bankers and legal advisers who made taxable supplies to it. Accordingly, ADIL paid VAT in respect of these services. At the time when ADIL incurred the liability to pay the VAT it was not registered for VAT and was not a taxable person for purposes of VAT.

Subsequent to the successful acquisition of BAA, ADIL joined the 'VAT group' of BAA (in terms of the UK VAT regime), at which point it became registered for VAT. ADIL, under the BAA VAT group, then sought to reclaim the VAT paid in respect of the said services.

The basis of ADIL's input VAT claim was that the services supplied to ADIL were in the course of an 'economic activity' carried on by it at that time, being the acquisition of BAA, and that the BAA VAT group's tax outputs should be attributed to ADIL's prior tax inputs. ADIL argued that the VAT incurred by it was part of the 'general overheads' of the BAA VAT group and that there was a 'direct and immediate' link to ADIL in connection with the takeover of BAA and the taxable supplies made by the BAA VAT group.

The two main issues were:

- Whether ADIL was carrying on an 'economic activity' when it incurred the liability to pay the input tax in respect of the services relating to the takeover bid.

- Whether there was a 'direct and immediate' link between (a) the supply of services to ADIL and (b) the taxable supplies made by the BAA VAT group, of which ADIL had subsequently become a member, and whose taxable supplies might be attributed to ADIL.

The court held that at the time ADIL incurred the liability to pay VAT in respect of the professional services rendered to it, ADIL's only intention was to acquire the shares of BAA. Even though the acquisition of the BAA shares was an act that would have economic consequences, it could not be equated to carrying on an economic activity for VAT purposes. At the time, ADIL did not make taxable supplies and did not intend to make taxable supplies. That finding dispensed with the contention that ADIL was, for VAT purposes, carrying on an economic activity. The attempt to reclaim input tax on the supplies of professional services to ADIL in connection with the takeover failed on that ground alone.

Also, there was no direct and immediate link between the input tax on the supply of professional services to ADIL and the output tax on the supply of taxable services made by BAA. At the relevant date, the supplies to ADIL were only in connection with the act of taking over BAA. They were unconnected to any supply that ADIL made or intended to make at the time. BAA's outward supplies in the course of its economic activity were not connected at the relevant date with the supplies to ADIL on which input tax was incurred. BAA's outward supplies and the VAT charged on them could not be attributed to ADIL to produce the requisite direct and immediate link between them.

continued

In the matter of *De Beers Consolidated Mines v Commissioner for the South African Revenue Service 74 SATC 330*, De Beers Consolidated Mines (BCSM) was approached by a consortium that proposed a complex structure in terms of which the consortium would become the holding company and the new owners of DBCM. DBCM appointed various advisors for purposes of finalising the transaction. The issue was whether DBCM could claim input tax for VAT purposes on the expenditure incurred.

What was clear from both the majority and minority judgment relating to direct costs was that the expenditure would only be allowed as a deduction to the extent that those costs could be said to have been directly linked to the enterprise but that subsidiary costs would not be allowed as a deduction. The issuing of shares would also not be allowed as a deduction.

In other words the VAT incurred in respect of services or goods acquired by the vendor must have been:

"...acquired by the vendor wholly for the purpose of consumption, use or supply in the course of making taxable supplies, or where the goods or services are acquired by the vendor partly for such purpose, to the extent (as determined in accordance with the provisions of section 17) that the goods or services are acquired by the vendor such purpose..."

General overhead costs such as audit fees and legal fees will generally not raise too much of an issue to the extent that the costs are close enough to the core of the business of the enterprise.

It is interesting to note that the UK court as well as the court in the case of DBCM considered the application of the economic activity test and direct and immediate link test in determining whether the VAT paid would be claimable as an input deduction. The courts clearly share similar reasoning. These two cases emphasise the potential VAT leakage that could occur in respect of transaction costs and set out the important factors that should be considered.

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