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SARS TAKES ANOTHER STAB AT INTERPRETING THE 'GROUP OF COMPANIES' DEFINITION

In our Tax Alert of 15 March 2013 we reported on the South African Revenue Services' (SARS') draft Interpretation Note on the interaction between the definition of a 'group of companies' as it appears in s1 and s41(1) of the Income Tax Act, No 58 of 1962 (Act). SARS embellished the draft Interpretation Note somewhat with the release on 24 October 2013 of Interpretation Note No 75 (IN 75) dealing with the exclusion of certain companies and shares from a 'group of companies' as defined in s41(1) of the Act. IN 75 has now been superseded by the release of Issue 2 of IN 75 on 22 September 2014.

The definition of a 'group of companies' in s1 of the Act is broader than the definition in s41(1) and the interpretation and interaction of the two definitions is critical in determining whether a particular transaction or distribution qualifies for tax relief under the corporate rules.

Given the circuitous interaction between the definition of a 'group of companies' in s1 and its definition in s41(1), it is helpful to restate them here:

A 'group of companies' is defined in s1 of the Act as meaning two or more companies in which one company, the controlling group company, directly or indirectly holds shares in at least one other company, the controlled group company, 'to the extent that – (a) at least 70% of the equity shares in each controlled group company are directly held by the controlling group company,

one or more other controlled group companies or any combination thereof; and (b) the controlling group company directly holds at least 70% of the equity shares in at least one controlled group company.'

For purposes of s41(1) a 'group of companies' is defined as meaning 'a group of companies as defined in section 1: Provided that for purposes of this definition – (i) any company that would, but for the provisions of this definition, form part of a group of companies shall not form part of that group if...' that company is:

- A co-operative, a company established in South Africa for the specified benefit of the general public or a sector thereof, or a foreign collective investment scheme in participation bonds or securities.
- A non-profit company as defined in s1 of the Companies Act, No 71 of 2008.
- A company the gross income of which is exempt from tax in terms of s10 of the Act.
- A public benefit organisation or recreational club approved as such in terms of s30 or s30A of the Act.
- A foreign incorporated association, corporation, company or body corporate unless it has its place of effective management in South Africa.
- A company that has its place of effective management outside South Africa.

Paragraph (i)(ff) of the proviso to s41(1) of the Act became operative on 1 January 2013 and applies to transactions

entered into on or after that date. The reference to the exclusion of such companies from the definition of a s41(1) 'group of companies' is the only substantive addition. For the rest it resembles its predecessor, released on 24 October 2013.

The second proviso deems certain equity shares not to be equity shares if they are held as trading stock; or any person is under a contractual obligation to sell or purchase them, or holds an option to sell or purchase them other than at their market value at the time of sale or purchase.

In brief IN 75 provides as follows:

- The corporate rules contained in ss41 – 47 of the Act provide tax relief for certain transactions (eg asset-for-share, substitutive share-for-share, amalgamation, intra-group, unbundling) and distributions on liquidation, winding-up and deregistration between companies within a 'group of companies' as defined in s41(1) of the Act.
- In order for a transaction or distribution between companies to qualify for tax relief under the corporate rules, the companies in question must form part of a more restrictively defined s41(1) 'group of companies.'
- Since the s41(1) definition commences with reference to the s1 definition of a 'group of companies', in applying the law and interpreting the s41(1) proviso, one must first ascertain whether the companies in question comprise a s1(1) 'group of companies' as defined. Assuming that they do, one proceeds to the s41(1) proviso to determine whether it operates to exclude any company or shares from consideration. If by operation of the s41(1) proviso, a company, for example a controlling group company, is excluded by virtue of its foreign incorporation and place of effective management, one must return to the s1 'group of companies' definition to establish whether the remaining companies constitute a s1 'group of companies.' If there is another controlling group company among the remaining companies that has not been excluded by operation of the s41(1) proviso, one may still have a s1(1) 'group of companies' that qualifies for tax relief under the corporate rules. However in the absence of a controlling group company, a 'group of companies' can no longer exist. As such the remaining companies will not qualify for tax relief in terms of the corporate rules.
- Legal precedent is cited in IN 75 in support of the principle that when interpreting the meaning of

legislation, one must construe the enacting clause (s1), the saving clause (s41(1)) and the proviso (s41(1) proviso) together.

- In addressing whether it may be discriminatory from a tax perspective to deny tax relief under the corporate rules to companies, the controlling group company of which is, for example, foreign incorporated and effectively managed; when similar companies with a South African resident controlling group company may well be afforded such relief; IN 75 categorically asserts that such denial, by virtue of the exclusion of such companies by operation of the s41(1) proviso, does not constitute tax discrimination under South Africa's tax treaties. The assertion is founded on the equality of treatment argument. South African resident companies that are exempt from South African income tax, as are foreign incorporated and effectively managed companies (other than on their South African sourced income and capital gains on the disposal of South African immovable property and/or assets of any permanent establishment they may have in South Africa), are similarly excluded from benefitting from such tax relief by operation of the s41(1) proviso.

IN 75 places beyond doubt SARS' rejection of the interpretation of the interaction between s1 and s41(1) proposed by the South African Institute of Chartered Accountants (SAICA). SAICA previously submitted that s41(1) requires only the determination of whether a 'group of companies' exists for purposes of the definition in s1(1) of the Act, from whence one must establish whether the s41(1) proviso operates to exclude certain specified companies from that group of companies for s41(1) purposes. SAICA asserts that there is no requirement to reapply the s1 'group of companies' definition to the companies remaining after the exclusion of specified companies by operation of the s41(1) proviso to establish whether a 'group of companies' still exists. However if one applies SAICA's proposed interpretation to the example above, after the exclusion of the foreign incorporated and effectively managed controlling group company from the s1 established 'group of companies' by operation of the s41(1) proviso, one would end up in the incongruous situation of one or more controlled group companies without a controlling group company, still constituting a 'group of companies.' Such conclusion would seem to neutralise the deliberate narrowing of the s1 'group of companies' definition by the s41(1) proviso.

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PROPOSED SIMPLIFICATION OF FOREIGN BUSINESS ESTABLISHMENT EXEMPTION FOR CONTROLLED FOREIGN COMPANIES

In terms of s9D of the Income Tax Act, No 58 of 1962 (Act), a South African tax resident can be taxed on the 'net income' of its controlled foreign companies (CFC). However, various exemptions exist in this regard.

For example, in terms of the second proviso to the definition of 'net income' in s9D(2A) of the Act, the net income of a CFC will be deemed to be nil if the taxes payable by that CFC in foreign jurisdictions are at least equal to 75% of the tax that the CFC would have paid had it been a South African tax resident. This is often referred to as the high-tax exemption. In performing the calculation regard must be had to any international treaties for the avoidance of double taxation, and tax credits or rebates.

Further exemptions are contained in s9D(9) of the Act, which effectively excludes certain amounts from being taken into account when determining a CFC's net income. The most notable exemption is the so-called foreign business establishment exemption, which excludes amounts attributable to any foreign business establishment that a CFC has from the net income calculation.

When performing the calculation for the net income of a CFC, it should first be determined whether the high-tax exemption applies and deems the net income of the CFC to be zero, before potentially proceeding with disregarding the relevant amounts excluded in terms of s9D(9) of the Act

from net income. Testing for whether the high-tax exemption applies can however be quite onerous, especially when a resident has multiple CFCs and the income in respect of those CFCs are in any event attributable to foreign business establishments.

In terms of the draft Taxation Laws Amendment Bill 2014 (Bill) that was released earlier this year, it is proposed to simplify the process where the foreign business establishment exemption applies to all the income of the relevant CFC. The Bill proposes that, similar to the high-tax exemption, the net income of a CFC also be deemed to be zero where 'all the receipts and accruals' of the CFC is attributable to a foreign business establishment.

The effect of the proposal is that it becomes unnecessary for a resident to first determine the hypothetical tax position of each of its CFCs and to only thereafter apply the foreign business establishment exemption if the high-tax exemption does not apply. Where all of a CFC's receipts and accruals are attributable to a foreign business establishment, the net income of the CFC will automatically be deemed to be zero and it would not be necessary to do any calculations in respect of the high-tax exemption.

This is a welcomed amendment to s9D of the Act.

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