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TAX ALERT

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CLIFFE DEKKER HOFMEYR

CONVERTING LOANS INTO EQUITY: ANOTHER SARS RULING

To fund its operational expenditure, a company resident in South Africa borrowed money from its non-resident holding company and other non-resident companies related to the holding company.

The subscription price would be equal to the total amount of the local company's indebtedness to the holding company and the related companies.

The issue of 'converting' loans into share capital remains a vexing one.

The matter was again the subject in Binding Private Ruling 213 (Ruling) issued by the South African Revenue Service (SARS).

The facts of the Ruling are common. To fund its operational expenditure, a company resident in South Africa borrowed money from its non-resident holding company and other non-resident companies related to the holding company.

The holding company proposed to subscribe for further ordinary no par value shares in the local company. The subscription price would be equal to the total amount of the local company's indebtedness to the holding company and the related companies. Notably, the subscription price would be paid in cash.

The local company would then use the cash to settle the capital of, and the interest on, the loans.

SARS ruled as follows in relation to the proposed transaction:

- The issue of the further ordinary no par value shares will not constitute a 'transfer' as defined in s1 of the Securities Transfer Tax Act, 2007 (STT Act). The issue of the shares would therefore not be subject to securities transfer tax.
- Section 8(4)(a) of the Income Tax Act, No 58 of 1962 (ITA) states that, if a taxpayer recovers any amount it previously deducted for income tax purposes, the taxpayer must include the amount in its income. For example, if a creditor of a taxpayer waives interest on a loan and the taxpayer previously claimed the interest as a deduction, then the taxpayer must include the amount of the waived interest in its taxable income. SARS ruled that this provision will not apply to the payment of the capitalised interest on the intercompany loans.
- Section 19 of the ITA and paragraph 12A of the Eighth Schedule to the ITA also apply where a creditor waives a debt (in cases other than those applying under s8(4)(a) of the ITA). Simply put, the taxpayer must account for income tax or capital gains tax on the amount waived. SARS ruled that these provisions will not apply to the repayment of the intercompany loans, or to the payment of the interest on the intercompany loans.

It is not clear why the taxpayer applied to SARS for a ruling. Firstly, in respect of securities transfer tax, the issue of shares is specifically excluded from the definition of 'transfer' in s1 of the STT Act. Secondly, it is clear that there is no question of a

CONVERTING LOANS INTO EQUITY: ANOTHER SARS RULING

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As noted in our Tax Alert of 9 October 2015, SARS has now issued a number of rulings indicating that the capitalisation of shareholder loans will not trigger the debt reduction provisions.

waiver of the capital or interest on the intercompany loans as these would be settled in cash.

Perhaps the taxpayer was looking for a ruling from SARS to the effect that the scheme as a whole, that is, the subscription for shares together with the settlement of the loans did not constitute impermissible tax avoidance under the general anti-avoidance rules (GAAR) in Part IIA of the ITA. However, SARS specifically included a note in the Ruling stating that it did not consider the application of the GAAR on the proposed transaction.

In other words, SARS did not commit itself to stating whether or not transactions of this kind give rise to impermissible tax avoidance under GAAR. Taxpayers are therefore still in the dark as to whether the 'conversion' of loans to equity are struck by the GAAR.

As noted in our Tax Alert of 9 October 2015, SARS has now issued a number of rulings indicating that the capitalisation of shareholder loans will not trigger the debt reduction provisions. However, these rulings apply only to the specific applicants, and the particular facts contained in the rulings. It accordingly remains to be seen what SARS's overall view is of transactions of this kind.

It would greatly assist if SARS were to issue some definitive guidelines. SARS has issued a draft Interpretation Note dealing with the reduction of debt. Under that draft document SARS does appear to accept in principle that the reduction of debt through the issue of shares may not trigger adverse tax consequences. However, SARS does say at page 9 of the draft document that its comments:

> 'must not be construed as sanctioning a situation in which the issue of shares, whether for cash or by set-off, is simply a sham transaction intended to disguise a waiver of debt. The facts and circumstances of each case will therefore have to be considered before it can be determined whether the issue of shares gives rise to a reduction amount.'

Taxpayers should, accordingly, continue to exercise caution when entering into transactions for the 'conversion' of loans into equity.

Ben Strauss

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The amendment essentially seeks to formalise the process of an employer requesting to be absolved from an employees' tax liability, by requiring that employer to complete a form for submission to the South African Revenue Service (SARS).

Where an employer fails to deduct the required employees' tax from remuneration under paragraph 2(1) of the Fourth Schedule, then in terms of paragraph 5(1) of the Fourth Schedule a personal liability is incurred for the unpaid amount.

The Taxation Laws Amendment Act, No 23 of 2015 (TLAA) contains an amendment to a somewhat odd provision, that has seemingly stood the test of time since the introduction of the Fourth Schedule into the Income Tax Act, No 58 of 1962. Paragraph 5(2) of the Fourth Schedule, dealing with absolving an employer from liability in respect of employees' tax, has now been amended to provide a more formal approach, when compared to its previous version, which is still riddled with discretionary powers.

The amendment essentially seeks to formalise the process of an employer requesting to be absolved from an employees' tax liability, by requiring that employer to complete a form for submission to the South African Revenue Service (SARS). It remains uncertain whether such a form must be submitted to SARS' Legal and Policy division or the local branch office – the former is preferred as the local branch office may not have been given the requisite discretionary powers to deal with the application. The effective date of the amendment is still to be determined by the Minister by way of Gazette. For reasons set out below, the more formal approach is welcomed but it may be more prudent for SARS to go a step further and issue an interpretation note or a binding general ruling on the practical application of paragraph 5(2) of the Fourth Schedule.

As a basic principle, paragraph 2(1) of the Fourth Schedule places an obligation on an employer who pays, or becomes liable to pay amounts by way of remunerati on, to deduct and withhold employees' tax, unless the Commissioner has granted authority to the contrary. Paragraph 4 of the Fourth Schedule goes further to state that the amount of employees' tax deducted is a debt due to the State and that the obligation to deduct or withhold employees' tax (unless directed otherwise) rests with the employer, as well as the ultimate liability and due payment thereof.

It was necessary for the legislature to provide a remedy, by way of paragraph 5(2) of the Fourth Schedule, where an employer unintentionally (which could be a very subjective test) failed to withhold or pay to the Commissioner the correct amount of employees' tax. Where an employer fails to deduct the required employees' tax from remuneration under paragraph 2(1) of the Fourth Schedule, then in terms of paragraph 5(1) of the Fourth Schedule a personal liability is incurred for the unpaid amount. Paragraph 5(1) of the Fourth Schedule is subject to paragraph 5(2) of the Fourth Schedule, meaning that the Commissioner may absolve an employer, despite the fact that a personal liability has been incurred. The reference to 'may absolve' establishes a discretionary power, the exercise of which could be subject to review.

Where the Commissioner does not exercise his discretion to absolve in favour of an employer, then paragraph 5(3) of the Fourth Schedule provides for a right of recovery by the employer of the unpaid employees' tax from the employee concerned. An employer may not issue an IRP5 tax certificate until such time as the employee's tax is recovered from the employee (paragraph 5(4) of the Fourth Schedule).

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The Commissioner must be satisfied that there is a reasonable prospect of ultimately recovering the tax from the employee – this would be done by way of assessing the employee for normal tax.

The mere act of absolving is not straight forward and an employer does not automatically qualify for the remedy. Regarding the previous wording of paragraph 5(2) of the Fourth Schedule, two basic, but not necessarily straightforward, requirements needed to be met before the Commissioner may decide to absolve an employer from employees' tax liability:

- the Commissioner must have been satisfied that the employer's failure to deduct or withhold employees' tax was not due to an intent to postpone payment of tax or to evade its obligations; and
- the Commissioner must be satisfied that there is a reasonable prospect of ultimately recovering the tax from the employee.

If one or both of the requirements, as mentioned above, were not satisfied then the Commissioner could not absolve the employer from liability under paragraph 5(1) of the Fourth Schedule. The amendment under the TLAA deleted the reference to '*... the Commissioner must be satisfied that ...*' and essentially replaced it with the formal approach, by way of application. The amendment doesn't appear to have taken away or reduced any of the discretionary powers in the provision, meaning that if the employer does in fact satisfy the minimum criteria, there still remains a discretionary power in the Commissioner's hands not to absolve the employer. From an employer's perspective it would be preferable to remove the additional discretionary power and amend the provision to oblige the Commissioner to absolve, if the minimum criteria is met. There are however certain practical impediments to the aforementioned, which is probably why paragraph 5(2) of the Fourth Schedule will remain riddled with discretion.

Intent to evade or postpone employees' tax liability

Under the first minimum requirement, the employer would need to prove, on a balance of probabilities, that it had no intention to evade or postpone its liabilities under the Fourth Schedule. For purposes of paragraph 5(2) of the Fourth Schedule an employer would need to mitigate its position by dealing with direct intent, indirect intent, *dolus eventualis* and negligence upon application.

In most cases, an employer would find an application under paragraph 5(2) of the Fourth Schedule will hinge on the potential negligence factor. The general test to determine negligence is to look at what the reasonable person would have done, if presented with the same set of circumstances. Payroll procedures, responsible persons and other relevant factual circumstances will come into play in determining whether negligence is present.

Reasonable prospect of ultimate recovery from the employee

The second minimum requirement has both a subjective test and practical impediment. The Commissioner must be satisfied that there is a reasonable prospect of ultimately recovering the tax from the employee – this would be done by way of assessing the employee for normal tax. Where the matter involves

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Where would SARS however draw the line on employee numbers and what would it regard as a 'reasonable prospect' to recover the tax? The aforementioned are both subjective considerations, coupled with the practical burden of having to assess individuals, rather than one employer.

only one or a handful of individuals, the process of ultimately recovering the tax from the employee will likely not have a material impact on the administrative burden of collecting taxes by SARS or be a drain on the financial resources of SARS.

But identifying the employee is only one factor to consider. If SARS is of the view that ultimate recovery of the tax is not possible, the employer would not be absolved. Where would SARS however draw the line on employee numbers and what would it regard as a 'reasonable prospect' to recover the tax? The aforementioned are both subjective considerations, coupled with the practical burden of having to assess individuals, rather than one employer. Clarity could be provided through a binding general ruling or an interpretation note.

Although paragraph 5(2) of the Fourth Schedule will now be formalised, it remains subject to a discretionary power and employers should consider carefully whether an application is in its best interest.

Ruaan van Eeden

CLIFFE DEKKER HOFMEYR

OUR TEAM

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

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

Mark Linington
Director
T +27 (0)11 562 1667
E mark.linington@cdhlegal.com

Dries Hoek
Director
T +27 (0)11 562 1425
E dries.hoek@cdhlegal.com

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

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

Lisa Brunton
Senior Associate
T +27 (0)21 481 6390
E lisa.brunton@cdhlegal.com

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

Mareli Treurnicht
Senior Associate
T +27 (0)11 562 1103
E mareli.treurnicht@cdhlegal.com

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

Gigi Nyanin
Associate
T +27 (0)11 562 1120
E gigi.nyanin@cdhlegal.com

Nicole Paulsen
Associate
T +27 (0)11 562 1386
E nicole.paulsen@cdhlegal.com

BBBEE STATUS: LEVEL TWO 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@cdhlegal.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@cdhlegal.com

CLIFFE DEKKER HOFMEYR