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TAX AND EXCHANGE CONTROL ALERT

IN THIS **ISSUE**

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ALL IN ONE: ANOTHER RULING REGARDING AN AMALGAMATION TRANSACTION

In our Tax and Exchange Control Alert of 20 May 2016, we discussed Binding Private Ruling 231 (Overruled: SARS expresses an interesting view on be an amalgamation transaction), in which the South African Revenue Service (SARS) ruled on whether the roll-over relief provisions in s44 of the Income Tax Act, No 58 of 1962 could be applied.

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The South African Revenue Service (SARS) has now issued a number of rulings on the matter of the "conversion" of debt to equity.

We have discussed previous rulings on this topic in our Tax Alerts of 15 January 2016 and 9 October 2015.

On 31 May 2016 SARS issued Binding Private Ruling 236 (Ruling) which again deals with the issue.

The Ruling involved a restructure of a group of companies. As part of the restructure, one company in the group (African Holdco) acquired a loan account in its wholly-owned subsidiary company (Foreign Holdco). Notably, African Holdco was a tax resident in South Africa, while Foreign Holdco was a tax resident in another country.

The restructure worked as follows:

- First, a company in the group (Applicant) sold certain shares to another company in the group (Foreign Holdco). The price was left owing on loan account (Loan).
- Second, the Applicant distributed the Loan to its holding company (Holdco) as a dividend *in specie*.
- Third, Holdco subscribed for further ordinary shares in the capital of African Holdco for a subscription price equal to the face value of the Loan. The obligation of Holdco to pay the subscription price to African Holdco under the subscription agreement was discharged by the transfer of the Loan to African Holdco. So, after the third step African Holdco held the Loan in its wholly-owned subsidiary, Foreign Holdco.
- Fourth, African Holdco in turn subscribed for further ordinary shares in the capital of Foreign Holdco for a subscription price equal to the face value of the Loan. The obligation of African Holdco to pay the subscription price to Foreign Holdco under that subscription agreement was discharged by way of set-off against the Loan, resulting in the Loan being extinguished.

It is the fourth step in the restructure that is of interest in the present case. SARS ruled as follows in relation that step, to the extent that it is relevant:

- For purposes of paragraph 20 of the Eighth Schedule of the Income Tax Act, No 58 of 1962, African Holdco acquired the further shares in Foreign Holdco for an expenditure equal to the subscription price of the shares. In other words, SARS accepted that, for capital gains tax purposes, the base cost of the further shares in Foreign Holdco would be an amount equal to the subscription price, that is, an amount equal to the face value of the Loan.

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SARS RULES AGAIN ON THE CAPITALISATION OF LOAN ACCOUNTS

CONTINUED

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- The set-off of the Loan against African Holdco's obligation to pay the subscription price did not give rise to any capital gain in African Holdco.

As African Holdco was not a tax resident in South Africa, it was not necessary to consider the South African tax effects of the restructure for it. Had it been a South African tax resident, it would have been interesting to see how SARS would have ruled on the tax implications of the extinction of the Loan. The reduction of a debt for inadequate consideration can in certain cases have negative tax consequences for South African tax resident debtors – see the Tax Alert of 15 January 2016.

SARS has never said in so many words that those debt reduction rules would legitimately be avoided if:

- a creditor subscribes for shares in a debtor company for a subscription price equal to the debt; and
- the obligation to pay the subscription price is set off against the obligation to repay the debt.

In a draft Interpretation Note, SARS does say that, in principle, the reduction of debt through the issue of shares ought not to trigger adverse tax consequences. It does appear as if the Ruling is a further acceptance by SARS that the capitalisation of a loan account by subscription and set-off – as opposed to a settlement for cash – ought not to have a negative tax effect.

Note that a SARS ruling only applies to the persons who requested the ruling. However, SARS's rulings do give taxpayers an idea of its view on matters addressed in the rulings.

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ALL IN ONE: ANOTHER RULING REGARDING AN AMALGAMATION TRANSACTION

The Applicant in this Ruling is a company incorporated in and a resident of South Africa (SA).

The Applicant and the Co-Applicants decided to rationalise the administration of their businesses, which have an identical underlying nature, by amalgamating the businesses in a single entity and terminating the existence of the existing companies.

In our Tax and Exchange Control Alert of 20 May 2016, we discussed Binding Private Ruling 231 (Overruled: SARS expresses an interesting view on be an amalgamation transaction), in which the South African Revenue Service (SARS) ruled on whether the roll-over relief provisions in s44 of the Income Tax Act, No 58 of 1962 (Act) could be applied. In this article, we discuss Binding Private Ruling 232 (Ruling), which also dealt with these provisions, although the context and facts of the Ruling are somewhat different. S44 states that parties to an amalgamation transaction will qualify for roll-over relief, whereby certain tax liabilities that would arise in the normal course are deferred, provided that the requirements of s44 are met.

Facts

The Applicant in this Ruling is a company incorporated in and a resident of South Africa (SA). There are three Co-Applicants in this ruling, namely the amalgamated companies (ACs), which are SA resident companies that will be wound-up as part of the amalgamation transaction, the shareholders (SHs) of the ACs, which are all SA resident companies and the resultant company (RC), which is also an SA resident company that will remain in existence after the amalgamation transaction.

Description and nature of the proposed transaction

The Applicant and the Co-Applicants decided to rationalise the administration of their businesses, which have an identical underlying nature, by amalgamating the businesses in a single entity and terminating the existence of the existing companies. The Applicant and the Co-Applicants have significant interests in investments in fixed properties, which they hold individually or jointly. The nature of the investments is in each case similar, comprising of shares in companies that own fixed property which is let to derive rental income. The amalgamation will result in the transfer of the assets and liabilities of the ACs to the RC, in exchange for shares in its corporate structure. Those shares will be issued on behalf of the ACs, after which the ACs will be wound up.

The RC will issue shares of different classes. Each class of shares will be linked to a designated property investment. The holders of these shares will each be entitled to a distribution of income and capital, attributable to the income and capital generated by the designated property. The distributions will not be limited to specified amounts. In the event of a winding-up, if there is any surplus remaining after satisfying the interests of the shareholders of each class, each share shall be entitled to share equally in the surplus. The rights of each class of shareholder will be documented in the memorandum of incorporation.

The relevant legal provisions

The provisions in the Act that are relevant for this Ruling are s44(1) and 1(1).

S44(1)(a) defines an amalgamation transaction as a transaction where:

1. any resident company disposes of all of its assets (other than assets it elects to use to settle any debts incurred by it in the ordinary course of its trade and other than assets required to satisfy any reasonably anticipated liabilities to any

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ALL IN ONE: ANOTHER RULING REGARDING AN AMALGAMATION TRANSACTION

CONTINUED

There are two interesting observations to make with regard to this Ruling.

sphere of government of any country and costs of administration relating to the liquidation or winding-up) to another resident company by means of an amalgamation, conversion or merger; and

2. as a result of which the existence of that amalgamated company will be terminated.

S1(1) of the Act defines an equity share as any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution.

Ruling

SARS ruled that the disposal by the ACs of their businesses to the RC will meet the requirements of an amalgamation transaction as defined in s44(1). The shares of the different classes to be issued by the RC will each constitute an equity share as defined in s1(1).

Comment

There are two interesting observations to make with regard to this Ruling. Firstly, the definition of an amalgamation transaction in s44(1)(a) refers to the disposal of assets by "...a...company which is a resident..." Whereas this phrase in the definition might have suggested that there may only be one amalgamated company to qualify for the roll-over relief, this Ruling could provide support for the argument that the assets of more than one amalgamated company may be transferred to a resultant company. In other words, the Ruling could suggest that under certain circumstances, it might not be necessary for each amalgamated company to conclude a separate amalgamation transaction with the resultant company, to qualify for the roll-over relief in terms of s44.

Secondly, the Ruling regarding the shares of different classes issued by the RC is important, in the context of s44(2) and s44(4) of the Act. S44(2) states, *inter alia*, that any capital gain that would have occurred had the property been disposed of in the normal course, will not trigger the payment of capital gains tax (CGT) and is deferred until the RC disposes of the property. However, s44(4)(a) states that this roll-over relief will only apply "...to the extent that such asset is so disposed of in exchange for consideration other than...an equity share or shares in the resultant company..." It is therefore crucial that the shares issued by the RC constitute equity shares as defined. In terms of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2010 (EM 2010), the definition of "equity share" was originally drafted to ensure that preference shares with limited dividend rights fall outside the definition and so that, *inter alia*, the benefits of s44 only apply where equity shares are issued as consideration for the capital asset received. The Ruling seems to confirm that this was the intention. Although the distribution of the income and capital received by the SH of a certain class of shares is dependent on the property investment to which the class of shares is linked, such shares still constitute equity shares, as defined, provided the distributions are not limited to specific amounts.

Taxpayers should still keep in mind that this Ruling is only binding on the parties to the transaction and that SARS will not necessarily adopt this approach in all similar instances.

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