DLA CLIFFE DEKKER HOFMEYR

# TAX ALERT

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## ANTI-AVOIDANCE: SHARE REPURCHASES THROUGH SUBSIDIARIES

Judgment was handed down on 16 November 2012 by the Tax Court in the case of *A Ltd v Commissioner for the South African Revenue Service*. The facts were as follows.

A Ltd was a company listed on the JSE. An employee share incentive scheme was being implemented at the time (2000-2001) in terms of which shares in A Ltd would have had to be delivered to employees in future. In order to hedge against price increases, a wholly-owned subsidiary, ALS, was set up to acquire and hold shares in A Ltd. ALS subsequently acquired A Ltd shares in the open market through an interest-free loan from another wholly-owned subsidiary of A Ltd. ALS was not authorised to own more than 10% of A Ltd shares. ALS transferred the A Ltd shares to the employee share incentive trust in 2003.

A Ltd had substantial amounts of surplus cash, and would have even more if A Ltd were to sell off a subsidiary, PTS. It was proposed during 2001-2002 that, unless better investments could be found, PTS should be sold and a 'repurchase' of A Ltd shares be implemented as this would be good for A Ltd's headline earnings per share.

It was understood that ALS would continue to be used to buy A Ltd shares. ALS then bought A Ltd shares in 2003. In order for ALS not to exceed the 10% limit, A Ltd bought back some of its own shares from ALS in 2004 and they were cancelled. ALS bought more A Ltd shares in 2004 and shortly thereafter A Ltd bought back more of its own shares from ALS.

Some A Ltd shares held by ALS was also disposed of by ALS to third parties in respect of other transactions. There were also further purchases by ALS of A Ltd shares in late 2004 and middle 2005.

All A Ltd shares held by ALS were sold back to A Ltd by the beginning of 2006 and cancelled. This was done in respect of a particular transaction that required a third party to acquire 100% of the issued shares of A Ltd.

In respect of each repurchase of A Ltd shares by A Ltd from ALS, the consideration payable in respect of the repurchase constituting a dividend, exemption from secondary tax on companies (STC) was claimed by A Ltd in terms of s64B(5)(f) of the Income Tax Act, No 58 of 1962 (Act). The section provides exemption in respect of dividends declared to group companies. If A Ltd directly bought back its own shares in the open market, and not through ALS, no exemption would have been available and A Ltd would have been liable for STC.

The Commissioner issued an assessment for STC to A Ltd in respect of the repurchases that took place during 2004 and 2006. The Commissioner's case was that the exemptions were claimed pursuant to a transaction, operation or scheme contemplated in s103(1) of the Act (as it read at the time) in order to avoid paying STC.

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In respect of the application of s103, the court noted that the following needs had to be established:

- Transaction: a transaction, operation or scheme was engaged in;
- Effect: the effect is avoidance or postponement of tax a liability;
- Abnormality: the transaction was entered into or carried out in a manner which would not normally be employed for *bona fide* business purposes other than obtaining a tax benefit, or created rights or obligations that would not normally be created between persons dealing at arm's length under a transaction of the nature of the transaction in question; and
- Purpose: the transaction was entered into or carried out solely or mainly for the purpose of obtaining a tax benefit.

In respect of the 'transaction' requirement, the court noted that the onus is on the Commissioner. In this case there were several transactions, but the Commissioner had to establish that they were steps in a single scheme of transactions or a unitary scheme. The court said that there must be sufficient unity between the earlier steps and the later steps so that it can be said that there is a unitary scheme, keeping in mind the 'ultimate objective'. The court found that, on the objective facts, there was no such unitary scheme. This was so because ALS had initially been established for hedging purposes in respect of the employee share incentive scheme and not in respect of selling the shares to A Ltd and cancelling them. Also, even though the repurchase programme envisaged that ALS would purchase A Ltd shares, it was not contemplated that the shares would be on-sold to A Ltd and cancelled. This was only done once ALS neared its 10% limit. Also, the last batch of A Ltd shares were only sold to A Ltd and cancelled to accommodate the transaction with the third party.

The court noted that as a prerequisite or jurisdictional requirement for applying s103 of the Act, the Commissioner must be satisfied that the various requirements are met, including the 'transaction' or 'scheme' requirement. The Commissioner must "stand and fall by his reasons for exercising the power", such as the reasons for being satisfied that the required elements were present. If the Commissioner contends in his statement of grounds of assessment that he was satisfied that there was a particular scheme, he cannot later at the hearing stage argue that he was satisfied that there was some other alternative scheme. In this case the Commissioner had always contended that he was satisfied that there was a scheme and that the scheme was the intentional interposition of ALS so that ALS could buy the shares in A Ltd and then A Ltd could buy those shares from ALS, a group company, and escape STC on the repurchase. In other words, the Commissioner saw the scheme as consisting of two steps, being the purchase of A Ltd shares by ALS and the subsequent purchase by A Ltd of those shares, and those two steps constituted one scheme. The Commissioner could not at the hearing stage accept that the first step may have been commercially justifiable, and proceed to attack only the second step, because that had never been his case. The Commissioner could not now argue that he was satisfied that there was a scheme that was different from the scheme that it had always argued it was satisfied of.

The court noted that failure to meet the 'transaction' requirement is sufficient cause for s103 of the Act not to be applicable, but in any event also considered the other requirements

In respect of establishing the 'effect' requirement relating to the avoidance of a tax liability, the onus is on the Commissioner – the Commissioner must prove that the 'scheme' had the 'effect' of avoiding STC. The court noted that A Ltd was under no obligation to buy its own shares and it would only do so if it made good commercial sense to repurchase its own shares. Also, the question had to be asked whether, if A Ltd had to directly purchase the shares in the open market and pay STC, it would have done so despite having to pay STC. The Commissioner did not show that that was the case.

In respect of the 'abnormality' requirement, the court noted that the onus is on the Commissioner. Abnormality has to be established objectively and comparisons may be made with persons in similar positions engaging in similar transactions, keeping in mind that what is abnormal as between unrelated parties may be normal as between parties with an existing special relationship. In this case it was established, partly by expert witnesses, that it is quite common for companies to hold treasury shares and to repurchase those shares.

In respect of the 'purpose' requirement, the court noted that the onus is on the taxpayer and that the subjective purpose of the parties is a question of fact. The purpose must at least be the dominant purpose over any other purpose. On the evidence the sole or main purpose for entering into the transactions was not to obtain a tax benefit. The purpose was to make an investment into A Ltd's own shares by holding them in treasury and not to sell them immediately to A Ltd and to cancel them. The sale of the shares to A Ltd only happened in circumstances that were not foreseen, such as accommodating the transaction with the third party.

Accordingly the taxpayer was successful and the appeal was upheld.

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