DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

20 MARCH 2014

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BUY-BACK OF SHARES AT A PURCHASE PRICE IN EXCESS OF THEIR MARKET VALUE

An interesting advance tax ruling was released by the South African Revenue Service (SARS) on 12 March 2014. Binding Private Ruling 164 (Ruling) deals with the buy-back of ordinary shares by a company at an amount in excess of the market value of the shares.

The facts of the proposed transaction are relatively simple. As part of a Broad-Based Black Economic Empowerment (B-BBEE) transaction, a company (BEECo) acquired 40% of the ordinary shares (shares) in a South African incorporated and resident company (applicant). The acquisition of the shares was financed by the BEECo through the issue of cumulative redeemable preference shares to various investors, the majority of which were financial institutions. As is typical in these transactions, the shares were used as security for the issue of the preference shares. If the BEECo failed to redeem the preference shares when due, the preference shareholders could take cession of the shares in satisfaction of the redemption obligations.

To ensure that the BEECo would not default on its preference share obligations, triggering the security arrangement mentioned above and compromising the applicant's B-BBEE status, it was proposed that approximately 20% of the entire issued share capital of the applicant would be bought back by the applicant. However, the buy-back of the shares would be for an amount in excess of their market value. The BEECo would use the proceeds from the buy-back of the shares to redeem all of the preference shares. The BEECo would then hold 25.1% of the applicant's ordinary shares and still satisfy the B-BBEE requirements.

Where a transaction is entered into at less than or more than market value, one of the immediate concerns is whether there is a donation, as defined in s55(1) of the Income Tax Act, No 58 of 1962 (Act), or a deemed donation, as contemplated in s58 of the Act, triggering the attendant donations tax implications.

In addition, and particularly where an asset is disposed of at less than market value, there may be a concern that the disposal triggers the deeming provisions contained in paragraph 38 of the Eighth Schedule to the Act. Paragraph 38 of the Eighth Schedule to the Act provides that a disposal of an asset must be treated as having been disposed of at market value in, amongst others, the following instances:

- the disposal of an asset by means of a donation; or
- the disposal of an asset to a connected person (as defined) for a consideration which does not reflect an arm's length price.

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Interestingly, and in line with a number of other advance tax rulings involving black economic empowerment transactions, SARS ruled that:

- the proposed buy-back of the shares by the applicant at an amount in excess of the market value thereof will not constitute a donation as defined in s55(1) of the Act, nor a deemed donation as contemplated in s58 of the Act; and

- the deemed disposal at market value provisions contained in paragraph 38 of the Eighth Schedule to the Act would not be applicable to the proposed buy-back of the shares.

Importantly, SARS appears to accept in the Ruling that there are commercial objectives to the buy-back of the shares at a price in excess of their market value, namely to maintain the applicant's B-BBEE status. This commercial objective appears to have satisfied SARS that:

i. the excessive purchase price for shares would not be paid with a gratuitous intention (or out of disinterested benevolence);

ii. the consideration in these particular circumstances would be adequate; and

iii. the consideration reflects an arm's length price (as contemplated in paragraph 38 of the Eighth Schedule to the Act).

The Ruling does not provide all the details of the proposed transaction. However, it is worth noting that if the buy-back of the shares by the applicant constituted a 'dividend' (as defined in the Act), for capital gains tax purposes, the proceeds from the disposal of the shares would be reduced by the amount of dividends, potentially eliminating capital gains tax consequences for BEECo (see paragraph 35(3)(a) of the Eighth Schedule to the Act). However, it is anticipated that a portion of the buy-back (ie at least the subscription price for the shares) would amount to a reduction in contributed tax capital and thus not constitute a dividend.

It is also interesting to note that, if paragraph 38 of the Eighth Schedule to the Act were to apply, it would have the anomalous result that the BEECo would be deemed to have disposed of the shares at market value, which would be less than the proceeds received from the buy-back of the shares.

Taxpayers must be mindful of the potential adverse tax consequences that may be triggered whenever a transaction is not implemented at market value. It is often recommended that taxpayers approach SARS for an advance tax ruling in such instances. However, it should be appreciated that SARS has the discretion whether or not to accept a request for an advance tax ruling on whether the amount paid for an asset constitutes a donation under s55(1) of the Act or a deemed donation under s58(1) of the Act (see s80(2) of the Tax Administration Act, No 28 of 2011).

Andrew Lewis

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RE-FINANCING AND BUY-BACK OF SHARES

The South African Revenue Service (SARS) released Binding Private Ruling 163 (Ruling) on 12 March 2014.

The Ruling deals with the tax consequences of a transaction involving the re-financing of various loans and the application of the proceeds for purposes of a share buy-back.

The facts are briefly as follows.

Company X owns 49.3% of the issued shares of company Y. The balance of the issued shares of company Y are held by various individuals, companies, trustees of trusts and executors of deceased estates (other shareholders).

It is intended that:

- company X would sell some of its shares in company Y to the other shareholders; and
- thereafter, company Y would repurchase the remaining shares from company X.

In other words, company X will exit as a shareholder of company Y.

Company Y has various subsidiaries. The subsidiaries are debtors in respect of four interest-free intra-group loans.

For purposes of carrying out the transaction:

- company Y will float a new company of which it will hold all the shares;
- the new company will acquire all the shares in the subsidiaries from company Y, in exchange for issuing more of its own shares to company Y;
- the subsidiaries will refinance their interest-free intra-group loans by obtaining interest-bearing bank funding;
- the subsidiaries will distribute the proceeds from the bank funding, together with surplus cash, to the new company as a dividend;
- the new company will also obtain a loan from bank;
- the new company will distribute the cash dividend received from the subsidiaries, together with the cash received from the bank in respect of its own loan, as a dividend to company Y; and
- company Y will use the cash dividend received from the new company to repurchase its own shares from company X.

The first issue that arose was whether the subsidiaries would be entitled to claim interest deductions in respect of the interest-bearing bank loans that would replace the interest-free intra-group loans.

Three of the four loans were obtained for purposes of financing working capital, building projects, and capital equipment for conducting business. The purpose of the fourth loan was initially to fund capital expenditure in respect of certain projects, but surplus funds would have been available to fund it. After the distribution, there would be no cash available for the projects and the subsidiary would have to borrow the funds again.

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SARS ruled that the interest incurred in respect of the first three loans would be allowed as a deduction under s24J(2) of the Income Tax Act, No 58 of 1962 (Act). However, the interest incurred in respect of the fourth loan would not be allowed. The reason for this is not entirely clear from the ruling, but it appears that the bank loan will be seen as having been obtained to fund the payment of the dividend, and would thus not meet the requirement of being incurred in the production of income.

The second issue that arose was whether the distribution by company Y to company X as consideration for the repurchase of the shares would constitute a dividend.

SARS ruled that it would constitute a dividend. This is so presumably because there would be no resolution by the board of company Y to the effect that the distribution would reduce the company's contributed tax capital.

SARS also ruled that the dividend would be exempt from income tax in terms of s10(1)(k)(i) of the Act, as well as exempt from dividends tax in terms of s64F(1)(a) of the Act (in that it constitutes a resident company to company dividend).

The ruling is welcomed in that, in our view, SARS has correctly applied the relevant tax principles and provisions of the Act.

Heinrich Louw

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