DLA CLIFFE DEKKER HOFMEYR

TAX

ALERT

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CONTRIBUTED TAX CAPITAL IN A COMPANY CONTEXT

The creation of contributed tax capital (CTC) and the return thereof by a company to its shareholders has been the subject matter of some misconception over the years.

The CTC of a company is a notional amount that is created pursuant to the subscription of shares by holders of a specific class of shares as consideration for the issue of those shares by the company. To the extent that a company has different classes of shares, the CTC of each class is ring-fenced and cannot be used to return to the holders of another class of shares. Effectively the CTC was traditionally seen to be the share capital together with share premium that arose pursuant to the issue of shares. Pursuant to the fact that the Companies Act, No 71 of 2008 now provides for the use of no par value shares, the CTC is effectively equal to such share capital that is created less any amounts that have been returned to shareholders.

The importance of a return of CTC is that it does not constitute a dividend and is thus not subject to dividends tax. However, in order for a company to return CTC to its shareholders, a specific resolution must be taken by the board or an appropriate committee that has been designated by the board to such effect. If no such resolution has been taken by the board, one cannot argue subsequently that there has been a return of CTC.

Equally, to the extent that one returns CTC to the holders of a specific class of shares, the CTC must be used proportionately in respect of all of the holders and cannot be returned to only selected holders of a class of shares. One cannot therefore return CTC to only Shareholder X in circumstances where Shareholder Y does not participate proportionately in any such return of CTC.

In terms of the current draft amendments to the Income Tax Act, No 58 of 1962 specific provisions will be inserted dealing with the CTC attaching to so called convertible shares. For instance preference shares are often issued in circumstances where they are convertible into ordinary shares. To the extent that the preference shares are issued, these preference shares constitute a separate class even though they may be converted subsequently into ordinary shares. Should the preference shares be converted into ordinary shares, the CTC attaching to the preference shares does not automatically 'transfer' to the CTC of the ordinary shares. In terms of the proposed amendments the CTC that attaches to the preference shares that are converted, will be transferred from the preference shares to the ordinary shares and deducted from the CTC reflected in respect of any remaining convertible

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preference shares. To the extent that the company receives any additional consideration pursuant to the conversion of the preference shares, such additional shares will also be reflected as part of the CTC in respect of the ordinary shares, ie the shares into which the preference shares have been converted.

The proposed amendment is welcomed as it provides clarity in respect of the previous uncertainty pertaining to the treatment of CTC associated with convertible shares.

Emil Brincker

TAX FREE SAVINGS ACCOUNTS

An overhaul of the current retirement dispensation and the promotion of savings has been on the cards since at least the 2012 Budget when the Minister of Finance announced that a series of discussion papers would be released on these matters.

It was revealed by National Treasury (Treasury) in a paper entitled *Strengthening retirement savings* (14 May 2012) that the reforms would include measures to encourage non-retirement household savings. The reason given was that, if long-term savings are locked up in retirement funds (as a result of proposed preservation requirements), individuals may be faced with difficulties in meeting financial obligations that may arise in the short to medium term. As a means of encouraging individuals to not rely on retirement savings for their short to medium needs, but to save additional amounts for such purposes, it was proposed that tax free savings accounts be introduced. Traditionally, the only incentive available for non-retirement household savings was the annual interest exemption for individuals.

A discussion paper was released by Treasury on 4 October 2012. Subsequent to that things went quiet and no details were mentioned in the 2013 Budget. However, in the 2014 Budget it was announced that tax free savings accounts would be introduced during 2014, which announcement was followed by a paper entitled *Non-retirement savings: Tax free savings accounts* (14 March 2014) which provided further details.

On 17 July 2014 Treasury released the draft Taxation Laws Amendment Bill 2014, which introduces the first draft of the long-awaited provisions relating to tax free savings accounts.

The provisions are structured around the concept of a 'tax free investment', which is defined as any financial instrument that meets certain requirements. Some of these requirements are that the financial instrument must:

- have been issued by a bank, long-term insurer, portfolio of a collective investment scheme in property or securities, or the government;
- be administered by an authorised user of a licenced exchange or certain financial service providers;
- be held by a natural person; and
- meet the requirements of relevant regulations.

The idea is that persons may invest in a variety of instruments, including unit trusts, exchange traded funds, fixed deposits, retail bonds, real estate investment trusts and certain insurance investment products, without paying tax on the returns or growth. These instruments will however be subject to strict regulation. It also appears that direct share purchases will be excluded.

From a technical perspective, any amounts received by or accrued to a person in respect of a tax free investment will be exempt from normal tax. Also, capital gains and losses will be disregarded in respect of the disposal of any tax free investments. An exemption in respect of dividends tax will apply to the extent that any income generated by a tax free investment constitutes a dividend.

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Tax free investments will however be subject to certain limitations. Specifically, a person will only be allowed to contribute R30 000 per year of assessment towards tax free investments, and a lifetime limit of R500 000 will apply.

Income and proceeds derived from tax free investments that are reinvested in tax free investments will not be subject to these limitations. In other words, the returns and growth on tax free investments may be capitalised free of any limitation.

Persons will also be allowed to transfer amounts from one fund to another without falling foul of the limitations, apparently to encourage competition between service providers.

However, a person will be penalised if the limits in respect of contributions are otherwise exceeded. Where the annual limit of R30 000 is exceeded, the amount of the excess will be taxed at 40%. A similar penalty will apply in respect of the lifetime limit of R500 000, however, amounts previously invested but withdrawn may again be reinvested up to the R500 00 limit (subject to the annual limit).

The amount must also be contributed in cash, as opposed to in the form of any other assets.

Tax free investments appear to be aimed at middle-income households. This is so because those falling below the tax threshold will not benefit from the incentive in the first instance, and the strict limits on contributions implies that high-income earners will have to put the bulk of their money elsewhere.

It is however an interesting question whether, despite the 40% penalty that applies in respect of exceeding the relevant limits, it might still be beneficial to an investor to put excess amounts in tax free investments. For example, an investor might be willing to pay the 40% penalty on the capital invested where it is guaranteed that all future income generated by the investment, as well as capital growth, would be tax free. Depending on the expected return, this could potentially make sense from a long-term investment perspective.

It is further interesting to note that Treasury has indicated that the annual interest exemption for individuals will remain for the time being, but will become less relevant to the extent that it is diminished as a result of inflation.

Heinrich Louw

PUBLIC BENEFIT ORGANISATIONS - LOWERING OF THE DISTRIBUTION REQUIREMENT

On 17 July 2014 the National Treasury (Treasury) released the draft Taxation Laws Amendment Bill (TLAB) which aims to give effect to the various tax proposals announced in the 2014 Budget.

One of the proposals relates to the control measures, and more specifically the distribution requirement, prescribed for a defined conduit public benefit organisation (PBO).

PBO's play an important role in society as they relieve the financial burden on the State in respect of undertaking public benefit activities. Tax exemptions and deductions are therefore available to assist PBO's in achieving their objectives.

In addition to the general tax exemption that applies to PBO's, s18A of the Income Tax Act, No 58 of 1962 (Act) provides for a deduction from the taxable income of any taxpayer an amount of any donation made by that taxpayer to defined PBOs and certain other organisations carrying on activities listed in Part II of the Ninth Schedule to the Act. This incentive is granted by government to encourage donations to organisations involved in public benefit activities.

A conduit PBO is a PBO approved in terms of s30 of the Act which provides funds or assets to other PBOs or entities conducting public benefit activities as contemplated in Part I and Part II of the Ninth Schedule to the Act. Conduit PBO's are also entitled to issue receipts for the deduction of donations in terms of s18A of the Act, provided that they distribute at least 75% of donations received to other approved PBOs and qualifying statutory bodies within 12 months of the end of the year of assessment in which the donation was received.

According to Treasury, the purpose of the 75% distribution requirement is to prevent conduit PBO's from amassing large reserves, and to align the timing in respect of when the donor claims a deduction and when the funds are pushed back into the economy (and presumably becomes gross income again).

However, the 75% distribution rule can actually hamper the effectiveness and sustainability of conduit PBO's. Recognising this, it was proposed in the 2014 Budget that the distribution requirement would be relaxed.

In terms of the draft TLAB the 75% threshold would be reduced to 50%. In addition, conduit PBO's will be allowed to earn passive income.

However, certain conditions will apply in respect of the use of undistributed funds, namely that 100% of returns on investments made by the conduit PBO must be distributed after 5 years from the date of the amendment, and every succeeding 5 year interval. Restrictions will also apply in respect of investing undistributed funds. Specifically, investments will be limited to certain financial institutions and speculative and/or illiquid investments will not be allowed.

Conduit PBOs should take note that they will have to amend their founding documents in order to reflect these new conditions.

It is proposed that the amendments come into operation on 1 March 2015.

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