TAX

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SCOPE OF CAPITAL GAINS TAX LIABILITY BROADENED

In order to provide the necessary legislative amendments required to implement the tax proposals that were announced in the 2015 National Budget on 25 February 2015, the National Treasury published the Draft Taxation Laws Amendment Bill (TLAB), 2015, on 22 July 2015 for public comment.

One of the proposed amendments relates to the definition of 'immovable property' as provided in paragraph 2 of the Eighth Schedule to the Income Tax Act, No 58 of 1862 (Act).

By way of background, paragraph 2 of the Eighth Schedule distinguishes between residents and non-residents for purposes of determining a capital gains tax (CGT) liability. Insofar as residents are concerned, CGT applies to any capital gain derived from the disposal of any capital asset irrespective of where the asset is situated. As far as non-residents are concerned, the CGT liability will only be triggered if the assets are capital in nature and constitute:

- fixed (immovable) property in South Africa;
- any interest or right of whatever nature of that non-resident to or in immovable property situated in South Africa; or
- any asset which is attributable to a permanent establishment of that non-resident in South Africa.

Paragraph 2(2) of the Eighth Schedule defines an 'interest in immovable property' situated in South Africa as:

- equity shares held by a person in a company or a vested interest in the assets of a trust if more than 80% of the market value of those equity shares is attributable to immovable property situated in South Africa; and
- in the case of a company or other entity, that person directly or indirectly holds at least 20% of the equity shares in that company or ownership or right to ownership of that other entity.

According to paragraph 2 of Article 6 of the Organisation of Economic Cooperation and Development (OECD) Model Tax Treaty, the term immovable property is defined to include "the rights to which the provisions of general law respecting landed property apply, usufruct of immovable property *and rights to variable or fixed payments as consideration for working of, or the right to work, mineral deposits, sources and other natural resources.*"

Having regard to the above, it is clear that the current definition of 'immovable property' in paragraph 2(2) of the Eighth Schedule is not aligned with the definition of 'immovable property' in the OECD Model Tax Treaty in that the current definition does not include the right to mine, prospecting rights, and right to work mineral deposits and other natural resources. Given South Africa's vast treaty network, the Explanatory Memorandum to the Draft TLAB proposes that the definition of the term 'immovable property' in paragraph 2(2) of the Eighth Schedule be closely aligned to that provided in paragraph 2 of Article 6 of the OECD Model Tax Treaty, to include the right to variable payments or fixed payment as consideration for the working of or right to work mineral deposits, sources and other natural resources.

It is intended that the proposed amendment will avoid any possible anomalies and thereby create legal certainty with regard to what constitutes immovable property for non-residents. The proposed amendment will come into operation on 1 January 2016 and will apply in respect of years of assessment commencing on or after that date. Public comments on the proposed amendments are due by close of business on 24 August 2015.

Gigi Nyanin and Nicole Paulsen

DLA CLIFFE DEKKER HOFMEYR

RULING ON ISSUE OF CAPITALISATION SHARES

The South African Revenue Service (SARS) issued Binding Private Ruling No 201 (Ruling) on 13 August 2015.

The Applicant, being a natural person, held 100% of the equity shares in a resident operating company (OpCo). OpCo, in turn, owned 100% of the shares in a dormant resident company (Co-Applicant). The parties wished to introduce a black-owned company (BEECo) as a shareholder in OpCo in order to improve its Black Economic Empowerment (BEE) credentials.

In order to achieve this, it was proposed that:

- OpCo would dispose of its shares in the Co-Applicant to the Applicant for nominal value;
- The Applicant would dispose of its ordinary shares in OpCo to the Co-Applicant in exchange for ordinary shares in the Co-Applicant (ie an asset-for-share transaction in terms of s42 of the Income Tax Act, No 58 of 1962 (Act));
- The Applicant would then hold 100% of the equity shares in the Co-Applicant and the Co-Applicant would hold 100% of the equity shares in OpCo;
- The Co-Applicant would issue 10 000 capitalisation shares to the Applicant for no consideration; and
- The Co-Applicant would issue 25.1% ordinary shares to BEECo for a negligible subscription price.

The 10 000 capitalisation shares would:

- be participating, cumulative, redeemable preference shares;
- be redeemable at the option of the Co-Applicant at 100% of the current equity value of OpCo;
- only have to be redeemed by the Co-Applicant if a default is triggered by the Co-Applicant falling into financial distress;
- entitle the Applicant to a cumulative preference dividend equal to the unredeemed balance of the redemption price of the shares, plus arrears, times 72% of the prime rate; and
- entitle the Applicant to 1% of all distributions made in respect of the ordinary shares.

SARS ruled that:

- The receipt by the Applicant of the capitalisation shares would not be seen as a disposal of the Applicant's ordinary shares in the Co-Applicant (presumably as a result of dilution), and the anti-avoidance provisions contained in s42(5) of the Act would not be triggered (Please refer to our Tax Alert dated 31 July 2015 for the latest developments regarding s42(5) of the Act);
- The Applicant will continue to hold a "qualifying interest" in the Co-Applicant subsequent to the issue of the capitalisation shares, and s42(6) of the Act will not be triggered;
- The receipt of the capitalisation shares would not constitute "gross income" in the hands of the Applicant, presumably because it is a capital receipt as opposed to a dividend, and would also not have to be included as an amount in respect of services rendered;
- The capitalisation shares would also not be subject to s8C of the Act;
- The capitalisation shares would not constitute a "dividend" or a "return of capital" as defined in s1 of the Act;
- The exchange of the Applicant's personal right to receive the capitalisation shares, for the actual capitalisation shares upon receipt will constitute a "disposal" by the Applicant, but will be disregarded for capital gains tax purposes (presumably because the base cost of the right would equal the proceeds, but this is unfortunately not made clear);
- The expenditure incurred by the Applicant in respect of the capitalisation shares will be deemed to be nil in terms of s40C of the Act; and
- No "contributed tax capital" will be created by the issuing of the capitalisation shares.

SARS did not make this ruling subject to any conditions or assumptions, but it did clearly indicate that the Ruling does not extend to any issues regarding company law, accounting treatment, or BEE accreditation.

Heinrich Louw

CONTACT US

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@dlacdh.com

Andrew Lewis
Director
T + 27 (0)11 562 1500
E andrew.lewis@dlacdh.com

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

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

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

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

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

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

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

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

cliffedekkerhofmeyr.com

DLA CLIFFE DEKKER HOFMEYR