5 FEBRUARY 2016

# TAX ALERT

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Real estate investment trusts (REITs) are subject to a special tax regime in South Africa.

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CLIFFE DEKKER HOFMEYR

# BUDGET ANALYSIS
## HOT OFF THE PRESS

**The Budget Speech to be delivered by the Honourable Minister of Finance Mr Pravin Gordhan on 24 February 2016 will probably be the most important Budget Speech since 1994.**

The CDH Tax Team will be presenting an analysis of the most important elements of the Budget Speech and proposed tax amendments that very same afternoon in Johannesburg. A presentation will also be held in Cape Town.

The analysis will be done in conjunction with Mr Johan Holtzhausen, Managing Director of PSG Capital.

Together this formidable team will take you through the various proposals and the current status of the South African economy.

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**DETAILS:**

**JOHANNESBURG:**
24 February 2016, 17:00 for 17:30, CDH Offices

**CAPE TOWN:**
25 February 2016, 8:00 for 8:30, CDH Offices

Please contact Harriet Tarantino at harriet.tarantino@cdhlegal.com or +27 11 562 1062 to book your seat. Please note that limited space is available and that seats will be allocated on a first-come-first-serve basis.

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2014
RANKED #1 BY DEALMAKERS FOR DEAL FLOW 6 YEARS IN A ROW
1st in M&A Deal Flow, 1st in M&A Deal Value, 1st in General Corporate Finance Deal Flow.
2013
1st in M&A Deal Flow, 1st in M&A Deal Value, 1st in Unlisted Deals - Deal Flow.
2012
1st in M&A Deal Flow, 1st in General Corporate Finance Deal Flow,1st in General Corporate Finance Deal Value, 1st in Unlisted Deals - Deal Flow.
2011
1st in M&A Deal Flow, 1st in M&A Deal Value, 1st in General Corporate Finance Deal Flow, Legal Advisor - Deal of the Year.
DealMakers

2013
HIGHEST RANKING
of Client Satisfaction amongst African Firms
Legal Week

NO.1
6
YEARS IN A ROW
for client service excellence
#6YearsInARow
pmr.africa

2015
1ST
South African law firm and 12th internationally for Africa & Middle East by deal value
2ND
South African law firm and 2nd internationally for Africa & Middle East by deal count
1ST
South African law firm and 15th internationally for Europe buyouts by deal value
MERGERMARKET

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FINANCIAL AND CORPORATE
RECOMMENDED FIRM
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# IS THE OECD'S BASE EROSION AND PROFIT SHIFTING ACTION PLAN ON TRANSFER PRICING FLEXING THE ARM'S LENGTH PRINCIPLE'S MUSCLES; OR PROPOSING A DIFFERENT PRICING STANDARD UNDER THE GUISE THEREOF?

*The tax payable by the benefitting party must be calculated as if the transaction had been concluded between independent parties transacting at arm's length.*

**Using South Africa as our departure point, s31 of the Income Tax Act, No 58 of 1962 (Act) provides that the tax payable in respect of international transactions is to be based on the arm's length principle.**

In brief, s31 of the Act provides that:

- where any transaction, operation, scheme, agreement or understanding (hereinafter, transaction) constitutes an 'affected transaction' has been concluded between connected persons; and
- such transaction contains a term or condition which differs from any term or condition that would have existed had the parties to the transaction been independent vis-à-vis one another and transacting at arm's length; and
- the term or condition results in a tax benefit for a party to the transaction; then
- the tax payable by the benefitting party must be calculated as if the transaction had been concluded between independent parties transacting at arm's length.

An 'affected transaction' is defined in s31 as an inter-jurisdictional transaction between a South African resident and a foreigner; a foreigner and another foreigner with a permanent establishment (PE) in South Africa to which such transaction relates; a resident and another resident with a PE outside South Africa to which such transaction relates; or a foreigner and any other person that is a controlled foreign company (CFC) in relation to any resident; and the transacting parties are connected persons vis-à-vis one another.

*Certain transitional provisions are found in s31 that deal with adjustments made prior to 1 January 2015, which were deemed to be loans, in the event that such loans had not been repaid by 1 January 2015.*

Any difference between the tax payable by a resident party to an affected transaction containing a term or condition offensive to the arm's length principle; and the tax payable by such party after the substitution of the offending term with a term or condition that conforms with the arm's length principle; in cases where the other party to the transaction is a foreigner or a resident with a PE outside South Africa to which such transaction relates:

- if that resident is a company, the difference is deemed to be a dividend *in specie* declared and paid by the resident to the other party; or
- if that resident is a person other than a company, the difference is deemed to be a donation made by the resident to the other party,

on the last day of the period of six months following the end of the year of assessment in which the adjustment is made. Certain transitional provisions are found in s31 that deal with adjustments made prior to 1 January 2015, which were deemed to be loans, in the event that such loans had not been repaid by 1 January 2015.

Section 31 also extends the arm's length principle to any transaction in respect of the granting of financial assistance or intellectual property. For purposes of determining whether the parties to such transactions are connected persons, s31 expands the connected person definition

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CONTINUED

*For transfer pricing (TP) purposes, the arm's length principle provides that the amount charged by one related party to another for a given product must be the same as if the parties were not related.*

in relation to companies (ie a connected person in relation to a company is any other company if at least 20% of the equity shares or voting rights in the company are held by that other company).

So what do we understand by the arm's length principle? Most South African taxpayers transacting internationally are aware that when they enter inter-jurisdictional transactions with foreign connected parties such transactions should be concluded on terms and at prices that are arm's length. Transacting at arm's length is generally understood to refer to the terms, in particular with regard to pricing, negotiated between independent parties transacting on the open market. For transfer pricing (TP) purposes, the arm's length principle provides that the amount charged by one related party to another for a given product must be the same as if the parties were not related. An arm's length price for a transaction is therefore what the price of that transaction would be on the open market between a willing buyer and a willing seller.

It is worth mentioning that even when independent parties negotiate the terms of an arm's length transaction, there may be concessions as between the parties; concessions which may, in isolation, not meet the arm's length test, but nevertheless form part of a transaction concluded between a willing buyer and a willing seller on the open market.

That noted, what is the OECD's stance on the arm's length principle?

Article 9 of the OECD Model Tax Convention (MTC) authorises profit adjustments according to principles of domestic law where an enterprise of one contracting state (eg South Africa) and an enterprise of the other contracting state (eg France), being states contracting for the avoidance of double taxation as between their respective jurisdictions by means of a double taxation agreement (DTA) modelled on the OECD MTC; are connected persons and the conditions made or imposed between such associated enterprises in their commercial or financial relations differ from those which would be made between independent enterprises, and one of the two enterprises would, but for those conditions, have made higher profits.

Using the South Africa/France DTA for purposes of discussion, Article 9 (Associated Enterprises) provides that where, for example:

- a South African enterprise participates directly or indirectly in the management, control or capital of a French enterprise or vice versa; or
- the same persons participate directly or indirectly in the management, control or capital of a South African enterprise and a French enterprise,

  (ie associated enterprises for purposes of the South Africa/France DTA); and
- in either instance conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises; then
- any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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*Under the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (approved by the OECD Council in 1995 and subsequently amended) (OECD TPG), the arm's length standard must be valued from the perspective of both parties.*

Thus where South Africa includes in the profits of a South African enterprise and taxes accordingly, profits on which a French enterprise has been charged to tax in France and the profits so included are profits which would have accrued to the South African enterprise if the conditions made between the two enterprises had been akin to those made between independent enterprises, then France is entitled to make an appropriate adjustment to the amount of the tax charged therein on those profits where France considers the adjustment justified. In determining such adjustment, due regard must be had to the other provisions of the South Africa/France DTA and the competent authorities of South Africa and France must consult each other as required.

It is clear that these provisions are aimed at targeting base erosion and profit sharing (BEPS) by preventing the systematic deviation of profits as between group enterprises from high to low tax jurisdictions.

Returning to the OECD MTC, the primary adjustment (ie the inclusion and subjection to tax in South Africa of profits which would have accrued to the South African enterprise if the conditions made between the two enterprises had mirrored those made between independent enterprises) provided for in Article 9 of the South Africa/France DTA must comply with the arm's length principle which precludes South Africa and France from using other allocation norms. So, what is the arm's length standard for purposes of the OECD MTC? Although the standard deals with the allocation of profits as opposed to the pricing of individual transactions, Article 9(1) of the OECD MTC is considered to be the authoritative statement of the arm's length principle and the legal basis for comparability analysis – being the analysis and comparison of independent enterprises engaged in the same or similar activities, under the same or similar conditions as those which characterise the transaction under scrutiny between associated enterprises, taking into account the functions performed, assets employed and risks assumed; in order to determine whether the rewriting of accounts is authorised under Article 9(1); and the determination of profits that would have accrued at arm's length in order to calculate the quantum of any rewriting of accounts.

Under the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (approved by the OECD Council in 1995 and subsequently amended) (OECD TPG), the arm's length standard must be valued from the perspective of both parties. The arm's length determination is accordingly the outcome that would have been achieved through a transaction between two independent enterprises, both transacting with the objective of maximising their profits.

Turning to the OECD BEPS Action Plan on TP, we find what can only be described as the arm's length standard on steroids. In applying the new arm's length standard, the legal contract evidencing the transaction is merely the analytical departure point. Applying the new analysis using intellectual property (IP) as our case study; all functions are to be analysed eg fundamental research,



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CONTINUED

*The outcome of the analysis of all the functions, including where they take place, by whom they are controlled, who bears the capital risk, and the determination of how functionaries are remunerated and the like; ultimately determines which entities will be taxed and the quantum on which they will be taxed.*

specific applied research, design and conception of invention, procedure for application of the patent, organisation of the production, actual manufacturing of the product, marketing, sales, distribution, maintenance and enhancement of the patent, financing of all or some of the stages, and then some. The outcome of the analysis of all the functions, including where they take place, by whom they are controlled, who bears the capital risk, and the determination of how functionaries are remunerated and the like; ultimately determines which entities will be taxed and the quantum on which they will be taxed. This outcome may or may not align with the incidence of tax as agreed to between the transacting parties under the legal contract negotiated between them.

According to the OECD BEPS Project leaders, the objective of the new arm's length test is to align taxation with effective value creation and to reconnect profits with business activities through risk and function analysis, thereby substantively linking revenue and expenditure with risks and functions, regardless of the legal contractual allocation of expenditure and profits as negotiated between the transacting parties.

Is this genuinely a buff new 'economic' arm's length standard, or something else? To reiterate, an arm's length price is the price negotiated for a transaction on the open market between a willing buyer and a willing seller; both transacting with the objective of maximising their profits. Some critics have suggested that the new arm's length standard proposed by the OECD is in fact 'formula apportionment'; an attempt by the OECD to establish an incontrovertible inter-jurisdictional line, which will ensure that the tax administration of each jurisdiction receives its fair share of tax revenue from any transaction concluded across both. And while the only way to determine what is fair is by recourse to the contractual terms regulating the transaction, this new test seems to be moving towards institutional relationship evaluation instead. This may not necessarily be a bad move, but let's call it what it is. The arm's length principle it is not.

*Lisa Brunton*

# REITS – A RECENT RULING ABOUT ‘QUALIFYING DISTRIBUTIONS’

*The term ‘qualifying distribution’ was the subject matter of a recent ruling of the South African Revenue Service (SARS), Binding Private Ruling: BPR 218 dated 1 February 2016.*

*As a REIT by its nature distributes most of its net income to its investors, the REIT itself usually pays little or no income tax; instead, the shareholder pays income tax on the distributions received from the REIT.*

**Real estate investment trusts (REITs) are subject to a special tax regime in South Africa.**

Put simply, a REIT may deduct for income tax purposes distributions made to its shareholders. As a REIT by its nature distributes most of its net income to its investors, the REIT itself usually pays little or no income tax; instead, the shareholder pays income tax on the distributions received from the REIT.

The distribution, however, is only deductible by the REIT if it falls within the definition of ‘qualifying distribution’ in s25BB(1) of the Income Tax Act, No 58 of 1962 (Act). Notably, to fall under the definition the REIT must meet one of the following requirements (among others):

(a) at least 75% of the gross income of the company during its first year of assessment that the company qualifies as a REIT (or a controlled company in relation to the REIT) must consist of rental income; or

(b) in any other case, at least 75% of the gross income of a REIT or a controlled company in the preceding year of assessment must have consisted of rental income.

The term ‘rental income’ is defined in s25BB(1) of the Act.

(Note that the provisions in paragraph (a) above were amended recently with effect from 1 April 2013, the date that the new REIT taxation regime was introduced. Before the change, the provision stated that “at least 75% of the gross income received by or accrued to a REIT or a controlled company until the date of the declaration of that dividend consists of rental income where a REIT or a controlled company is incorporated, formed or established during that year of assessment”.)

The term ‘qualifying distribution’ was the subject matter of a recent ruling of the South African Revenue Service (SARS), Binding Private Ruling: BPR 218 dated 1 February 2016.

The facts of the ruling were these: The first financial year and first year of assessment of a newly incorporated local company (NewCo) ended on 30 June 2015. NewCo listed on the JSE shortly after 30 June 2015 after concluding an amalgamation transaction with a portfolio created as a collective investment scheme in property (CISP).

As from its listing, NewCo started trading as a corporate REIT.

The CISP, under the regulatory requirements pertaining to its industry, converted its business to a corporate structure which was housed in NewCo. The conversion became effective on 1 July 2015. It consisted of the transfer of the assets and liabilities of the CISP to NewCo in exchange for the CISP receiving shares or linked units in NewCo, on the basis that those shares or linked units were issued on behalf of the CISP to the unit holders. The CISP was thereafter



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# REITS – A RECENT RULING ABOUT 'QUALIFYING DISTRIBUTIONS'

CONTINUED

*Newly formed REITs must take great care at the time of their formation and listing to ensure that the distributions they make after their formation do in fact constitute 'qualifying distributions'.*

voluntarily wound up. The conversion constituted an 'amalgamation transaction' under s44 of the Act.

Notably, NewCo conducted no business activities and earned no income before the conversion.

NewCo would make distributions for its year of assessment ending 30 June 2016, being its first year of earning rental income and its first year to be assessed as a REIT.

The distribution in respect of its 2016 year of assessment (to be determined with reference to its financial results for the financial year ending 30 June 2016) will only be made after 30 June 2016, once its financial results have been finalised, unless an interim distribution is made during the course of the 2016 year of assessment, in accordance with the manner in which REITs ordinarily make distributions.

SARS ruled that the provision in paragraph (a) cited above did not apply as the distribution would only be made after 30 June 2016. Instead, in establishing whether 75% of the gross income of NewCo consists of 'rental income', in order for it to make a 'qualifying distribution' for its year of assessment ending 30 June 2016 - that is, its first year of assessment as a REIT - the applicable year of assessment to consider will be the year of assessment in which NewCo was incorporated, which ended on 30 June 2015. Accordingly, one must have regard to paragraph (b) cited above.

However, on the facts of the ruling, NewCo had no 'rental income' in its year of assessment ending on 30 June 2015. Accordingly, NewCo would not have been making a 'qualifying distribution' in its 2016 year of assessment.

However, SARS nevertheless ruled that NewCo will comply with the provisions of paragraph (b) and that NewCo would be making a 'qualifying distribution' in respect of the 2016 year of assessment (provided that all the other requirements of the definition are met).

The ruling shows that newly formed REITs must take great care at the time of their formation and listing to ensure that the distributions they make after their formation do in fact constitute 'qualifying distributions'.

*Ben Strauss*



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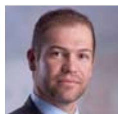

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